S. HRG. 109–1064

INSURANCE REGULATION REFORM

HEARING

BEFORE THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

ON

EXAMINING THE REGULATION OF INSURANCE AND THE INSURANCE INDUSTRY

JULY 11, 2006

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.access.gpo.gov/congress/senate/senate05sh.html

U.S. GOVERNMENT PRINTING OFFICE

49–529 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

C O N T E N T S

TUESDAY, JULY 11, 2006

	Page
Opening statement of Chairman Shelby	1
Opening statements, comments, or prepared statements of:	
Senator Johnson	2
Senator Reed	3
Senator Sununu	4
Senator Bunning	5
Senator Sarbanes	6
Senator Carper	30
Senator Menendez	33

WITNESSES

Alessandro Iuppa, Maine Superintendant of Insurance, and President, National Association of Insurance Commissioners	6
Prepared statement	49
John D. Johns, Chairman, President, and CEO, Protective Life Corporation	8
Prepared statement	70
Thomas Minkler, President, Clark-Mortenson Agency, Inc.	10
Prepared statement	76
Joseph J. Beneducci, President and COO, Fireman's Fund Insurance Company	13
Prepared statement	83
Jaxon White, Chairman, President, and CEO, Medmarc Insurance Group	14
Prepared statement	88
Alan F. Liebowitz, President, Old Mutual (Bermuda) Ltd.	38
Prepared statement	93
Robert A. Wadsworth, Chairman and CEO, Preferred Mutual Insurance Company	39
Prepared statement	98
Travis Plunkett, Legislative Director, Consumer Federation of America	41
Prepared statement	104
Robert M. Hardy, Jr., Vice President and General Counsel, Investors Heritage Life Insurance Company	43
Prepared statement	135
Scott A. Sinder, Member, The Scott Group	45
Prepared statement	138

INSURANCE REGULATION REFORM

TUESDAY, JULY 11, 2006

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:08 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. The Committee will come to order.

Today's hearing will inaugurate a series of hearings that the Committee will hold this year on insurance regulation. The purpose of these hearings is to continue the Committee's historical oversight of the insurance industry and, in particular, to determine how insurance regulations can be strengthened and perhaps modernized. Although the McCarren-Ferguson Act delegated primary responsibility for insurance regulation to the States, the health of the U.S. insurance market is a national concern. The American economy depends on the existence of a dynamic and robust insurance market, as insurance protects American businesses and consumers from financial loss and empowers them to plan for their financial futures.

Because of the security provided by insurance, American entrepreneurs have better positions to take the financial risk necessary to create new businesses and, of course, jobs. Without widespread availability of insurance at reasonable rates, the American economy would unquestionably be less entrepreneurial, less productive, and less competitive.

Insurance products also play a central role in the retirement plans of millions of Americans and provide invaluable assistance to many following life's most tragic moments, such as the death of a spouse or a parent. Private insurance is our Nation's first line of defense in protecting Americans from financial distress.

Yet, in order for the U.S. insurance market to work for American consumers today and in the future, it is essential that insurance regulation keep pace with the changes in the marketplace and technological development. How insurance is regulated has a direct impact on whether the U.S. insurance market has the capacity and ability to pay claims, the flexibility to develop new products in response to changing consumer demand, and the strength to insure Americans at reasonable rates. Making sure that U.S. insurance regulation is the world's most advanced and up-to-date, therefore, has real world consequences for American consumers.

My hope for today's hearing is twofold. First and foremost, I think that it is important that this Committee thoroughly understand the most pressing regulatory insurance reform issues. No system of regulation is perfect, but we can only begin to make the needed improvements once we understand the problems and the issues that are at stake.

Second, I am interested in learning about all of the potential options for the modernization of the insurance regulations. Insurance is too important to too many Americans for us not to examine all of our options for modernizing our system of insurance regulation.

And I am pleased that two members from this Committee, Senator Sununu and Senator Johnson have already been working on ways to modernize insurance regulation. I commend them for their innovative work and their willingness to tackle such a daunting task as insurance regulation reform. I look forward to learning more about their proposals and also learning more form other witnesses.

I want, in advance, to thank all of the witnesses for being here today and, at this time, Senator Johnson. I believe you were here first.

STATEMENT OF SENATOR JOHNSON

Senator JOHNSON. Thank you, Chairman Shelby, and also I appreciate the concern expressed by ranking member Sarbanes and his staff. Both of your staffs have been very helpful.

I want to thank you for holding what I hope is the first in a series of hearings on the very important issue, an urgent issue, of regulatory reform of the insurance industry. The last time this Committee held a hearing on this issue was back in 2004. And it is safe to say, frankly, that very little progress has been made in this area on either the State or the Federal level since that time.

There is a widespread consensus that the *status quo* is unacceptable. The question now is, what should be done to change that? As you know, Senator Sununu and I have come up with what we believe is a reasonable solution and what I truly believe is the right approach, an optional Federal insurance charter.

I have heard many arguments both for and against the regulation of insurance, and I have to say that I, at this point, am not convinced that all 50 States will ever be able to come together on what we all agree is desperately needed, and that is uniform standards.

But this is not a simple issue, and therefore there is no simple solution. Nonetheless, insurance companies both small and large, agents and brokers, and, most importantly, consumers, should all have the benefit of a system of regulation that fosters competition, while allowing the greatest protections and the greatest choices.

None of those ideals should be hindered or diminished by regulatory reform efforts, rather they must be enhanced. Consumers should have the benefit of knowledgeable and responsible agents and brokers who represent well-regulated and financially sound companies.

Insurance companies, whether they are local, regional, national, or global, must be able to grow to compete and offer innovation products and services. There is no reason why this country's insur-

ance industry, its agents, brokers, and consumers they serve, should be hamstrung by a system of regulation that I have heard described as redundant, inefficient, burdensome, complicated, duplicative, costly, dysfunctional, anachronistic, balkanized, contradictory, deficient, and counterproductive.

Now, maybe somebody can think of some more descriptions than that, but that is just a handful of what was shared with me over the years, despite the fact that, obviously, we have many very able State regulators and very many States that have tried hard to do a good job.

Congress called for State reform of insurance regulation in Gramm-Leach-Blilely. The message we are willing to send now is, if you cannot do it, we will do it for you.

I want to thank each of the witnesses that have taken the time to appear before us today to help the Committee better understand the current system, or lack of system, of insurance regulation. I look forward to hearing your recommendations for meaningful and effective reform.

And it is my hope that at the conclusion of today's hearing, we will leave armed with a good sense of the right approach to addressing, and addressing in a prompt fashion, this critically important issue.

Thank you, Mr. Chairman.

Senator SHELBY. Senator Hagel.

Senator HAGEL. No statement. I look forward to the witnesses. Chairman, thank you.

Senator SHELBY. Senator Reed.

STATEMENT OF SENATOR REED

Senator REED. Well, thank you very much, Mr. Chairman. I think this is a very timely and important hearing. The insurance regulation system in the United States faces challenges and we need to, I think, examine it at this point. If we look at a global economy as well as the emerging products and emerging technologies, insurance companies comprise a significant sector of our economy. Over 1,000 life and health insurance companies, and over 2,000 property and casualty insurance companies generate $540 billion and $430 billion in premiums, respectively.

Insurance companies, unlike banks and other financial institutions have been regulated by the States for the past 150 years, and although a number of changes in the regulatory system have been proposed at the Federal level, the system has remained largely untouched. Gramm-Leach-Blilely further clarified the State's authority to regulate insurance companies.

The decentralized nature of insurance regulation has prompted calls for a revision of the current system to make it more uniform and efficient.

However, there is a widespread disagreement as to what approach should be taken to achieve this efficiency and this uniformity. The proposal to transfer State regulatory functions to the Federal Government will likely bring about a healthy debate. We are beginning that debate today. With that said, I think we must continue to insist upon strong consumer protections as part of any changes to our regulatory structure.

Modernizing our regulatory structure should not be an excuse to undermine consumer protections. This is, obviously, a complicated and important issue. I look forward to this hearing and future hearings as we examine the impact of the current system of regulation on the insurance industry.

Thank you, Mr. Chairman.

Senator SHELBY. Senator Sununu.

STATEMENT OF SENATOR SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman. I certainly want to commend you on convening yet another quiet hearing on a dull, sobering issue, like insurance regulation.

Senator SHELBY. It will be quiet.

Senator SUNUNU. I hope the fire marshals are not in the facility. It is especially nice, though, to see that we have got a number of colleagues here to talk about. And to listen to our witnesses about a very interesting, somewhat complex subject described in, I think, effective detail by you, Mr. Chairman, by Senator Johnson, and Senator Reed. And that is, how best to insure efficient regulation of the insurance markets.

You detailed the key issues, here. We have an industry that is certainly national and is increasingly global in its scope and reach, but we have a regulatory system that is still highly fragmented and, indeed, local.

It is but one small example, but I think it is worth mentioning, that when you have regulators that stipulate whether or not paper clips or staples are allowed in filings, then I think it is fair to ask the question whether that is a system that really serves its constituents, clients, and consumers well.

It is a fragmented system, and as a result it is fair to say that it is a costly system. It is costly to underwriters, but ultimately, the burdens and costs of such a system are borne by consumers. Borne by consumers not just in higher prices, but borne by consumers because they suffer the results of less innovation, less product development, slower product introduction in the marketplace.

Senator Johnson and I worked for a long time on this legislation. And, fortunately, we got it perfect.

[Laughter.]

Senator SUNUNU. We do think that it is a better system. We do feel that it is a better approach. We do think it is the right approach, overall, but we also recognize that, perhaps most important, it is a framework for this debate. Something substantive and specific that people can look at, reflect on, critique, and work to improve.

There is a recognition, Senator Reed pointed out, that national regulation is required at this stage. Legislative proposals have been circulated in the House. And I think that underscores the understanding, a broad consensus, that some action is necessary. And this is not necessarily a new realization. As I have quoted here before, and will do so again, in 1871, George Miller, who was, at the time, insurance commissioner of New York, noted, clearly and unequivocally, that the State insurance commissioners are now fully prepared to go before their various legislative committees with recommendations for a system of insurance law which shall be the

same in all States. Not reciprocal, but identical. Not retaliatory, but uniform.

This is a recognition by the commissioners themselves 135 years ago that we needed a national system of uniformity. And that was well before we had communications infrastructure, the information technology infrastructure, the national markets and the global markets that we all have come to understand very well, today.

So, I think it is high time that we had a discussion that centered around a specific proposal, and I look forward to the witnesses' testimony.

Thank you, Mr. Chairman.

Senator SHELBY. Senator Bunning.

STATEMENT OF SENATOR BUNNING

Senator BUNNING. Thank you, Mr. Chairman.

For the most part, Congress and the Federal Government have left the regulation of life, and property, and casualty insurance alone. In fact, Congress explicitly granted the States regulatory responsibility of those insurance products, and that system has worked for many years.

Today's hearing is an important first step in considering whether the creation of a new Federal regulatory system will improve this sector for both insurers and the insured or simply add more bureaucratic mess.

Congress regulates many parts of the economy, with the financial industry being one of the most heavily regulated sectors. Over 69 years have passed since the Supreme Court ruled that Congress has the power to regulate insurance. And there is still no Federal insurance regulator.

This speaks volumes. We need to move with extreme caution when talking about reversing the entire history of insurance regulation in this country. There should be a high hurdle for expanding the Federal bureaucracy and imposing new regulations.

Once involved in a new area of regulations, Congress has the tendency to create monsters of bureaucracies that only grow and never go away. Before we go down that road, there must be clear evidence that the current system is broken and that there are no better alternatives.

So far, I have not seen that evidence. Certainly, greater cooperation between the States would be very beneficial. Licensing and product approval are areas where States could improve coordination. In today's modern and mobile society, some cross-border restrictions simply do not make sense.

Some efforts are underway to address these problems. Time will tell what kind of differences they make. Perhaps there are things Congress can do to make a difference. I just hope that we do not rush to judgment and do something that everyone will regret.

I look forward to hearing from our witnesses. Thank you, Mr. Chairman.

Senator SHELBY. Senator Crapo, do you have a statement?

Senator CRAPO. No opening statement, Mr. Chairman.

Senator SHELBY. Senator Sarbanes, do you have an opening statement?

STATEMENT OF SENATOR SARBANES

Senator SARBANES. Well, thank you very much, Mr. Chairman. I will just summarize very quickly, because I know we have a number of distinguished witnesses this morning. This is, of course, an important part of the jurisdiction of this Committee, and I want to commend the Chairman for examining this issue, which has been raised by a number of people.

I do want to make the observation that the issue of a Federal charter raises a number of far-reaching questions. We have traditionally left insurance regulation essentially to the State Governments. This would, in effect, encompass a major shift in that attitude. And some of the proposals that have been put forward carry with them very strong preemption provisions.

It is also an optional move, so those to be regulated would be able to choose their regulator, which raises some interesting hypothetical possibilities.

So, Mr. Chairman, I know we have an extended list of witnesses today, and I think you planned other hearings, as well——

Senator SHELBY. We did.

Senator SARBANES. ——on this subject, as I understand it. And I think that is the way to approach this issue. I think it has to be examined very thoroughly, very carefully, and with an understanding and an appreciation that we are raising the question of fundamentally altering the regulatory landscape. I am not prejudging that, but I do think that it is a matter of some import and consequence, and we need to keep that in mind.

Thank you very much.

Senator SHELBY. Thank you, Senator Sarbanes.

The witnesses on the first panel are the Honorable Alessandro Iuppa, president of the National Association of Insurance Commissioners, and Maine Superintendent of Insurance.

Mr. John D. Johns, president and CEO of the Protective Life Corporation.

Mr. Thomas Minkler, president of Clark-Mortenson Agency, Inc.

Mr. Joseph Beneducci, president and COO, Fireman's Fund.

And Mr. Jaxon White, president and CEO, Medmarc Insurance Group.

I will introduce the second panel later.

We will start with you, Mr. Iuppa. I hope I got your name right; is that right?

STATEMENT OF ALESSANDRO IUPPA, MAINE SUPERINTENDENT OF INSURANCE, AND PRESIDENT, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. IUPPA. That was very close. I will answer to anything, close, that is. But thank you very much.

Chairman Shelby, Senator Sarbanes, and members of the Committee, thank you for inviting me to testify before the Committee on insurance regulation reform. As you heard, my name is Alessandro Iuppa. I am the Superintendent of Insurance for the State of Maine, and I currently serve as president for the National Association of Insurance Commissioners, otherwise known as the NAIC.

I am pleased to be here on behalf of the NAIC and its members to share with the Senate Banking Committee the status of the State system of insurance supervision.

Today, I would like to make three basic points. First, State insurance officials strongly believe that a coordinated national system of State-based insurance supervision has met, and will continue to meet, the needs of the modern financial marketplace, while effectively protecting individual and commercial policyholders.

State insurance supervision is dynamic, and State officials work continuously to retool and upgrade supervision to keep pace with the evolving business of insurance that we oversee.

A perfect example of our success is the interstate compact for life insurance and other asset preservation insurance products. Twenty-seven States have joined the compact in just 27 months, with more on the way. And we plan for this State-based national system, with its single point of entry and national review standards to be fully operational in early 2007.

The interstate compact, though, is but one example. NAIC members have modernized the State system across the regulatory spectrum to implement multi-State platforms and uniform applications. We have leveraged technology and enhanced operational efficiency, while preserving the benefits of local protection, which is the real strength of the State system.

Second, your consideration of this issue must begin with the understanding that insurance is a unique and complex product that is fundamentally different from other financial services, such as banking and securities. Consequently, the State-based system has evolved over the years to address these fundamental differences.

Unlike banking products, which provide individuals up-front credit to obtain a mortgage or to make purchases, or securities, which offer investors a share of a tangible asset, insurance products require policyholders to pay premiums in exchange for a legal promise, rooted in contractual and torte laws of each State.

It is a financial guarantee to pay benefits, often years into the future, in the event of an unexpected or unavoidable loss that can cripple the lives of individuals, families, and businesses.

In doing so, insurance products inevitably touch a host of important and often difficult issues that generally are governed at a State level. State officials are best positioned to respond quickly and to fashion remedies that are responsive to local conditions.

We are directly accountable to consumers who live in our communities and we can more effectively monitor claims handling, underwriting, pricing, and marketing practices.

Third, despite State's long history of success protecting consumers and modernizing insurance supervision, some propose to radically restructure the current system by installing a new Federal insurance regulator, developing a new Federal bureaucracy from scratch, and allowing insurance companies to opt out of comprehensive State oversight and policyholder protection.

Risk and insurance touch the lives of every citizen and the fortunes of every business, and the Nation's insurance officials welcome Congressional interest in these issues. However, a bifurcated regulatory regime, with redundant and overlapping responsibilities will result in policyholder confusion, market uncertainty, and other

unintended consequences that will harm individuals, families, and businesses, that rely on our insurance for financial protection against the risks of everyday life.

For these reasons, the Senate Banking Committee and Congress should reject the notion of a Federal insurance regime. The system of State insurance supervision in the United States has worked well for more than 135 years. State regulators understand that protecting America's insurance consumers is our first responsibility.

We also understand that commercial insurance markets have changed, that modernization is needed to facilitate more streamlined, harmonized, and efficient regulatory compliance for insurers and producers.

The NAIC and its members will continue to share our expertise with Congress, and we respectfully ask that Congress and the insurance industry market participants work with us to further fully implement the specific improvements set forth in our modernization plan.

As our progress to date shows, a modern State-based system is the best, most practical way to achieve the necessary changes quickly, in a manner that preserves and enhances State protections that consumers demand. The Nation's insurance consumers require a financially sound and secure marketplace that offers a variety of products and services. They now have this through an effective and responsive State regulatory system.

When our record of success is measured against the uncertainty of changing a State-based system that works well, at no cost to the Federal Government, State insurance officials believe that Congress will agree that supervising insurance is best left to home State officials who have the expertise, resources, and experience to protect consumers in the communities where they live.

Thank you for the opportunity to speak with you today, and I look forward to your questions.

Senator SHELBY. Mr. Johns.

STATEMENT OF JOHN D. JOHNS,
CHAIRMAN, PRESIDENT, AND CEO,
PROTECTIVE LIFE CORPORATION

Mr. JOHNS. Thank you, Mr. Chairman, and Members of the Committee. I very much appreciate the opportunity to provide you and Members of the Committee——

Senator SHELBY. Can you bring the mic a little closer.

Mr. JOHNS. Is that better? Can you hear me? Thank you.

I really appreciate the opportunity to be with you today on behalf of the American Council of Life Insurers, which is the primary trade association for the life insurance industry, to express our perspective on the pressing need for Congress to comprehensively modernize our system of insurance regulation.

This issue is at the very top of our list or priorities that is set forth each year by a board of directors, of which I am a member. As the principle trade association for life insurance companies, the ACLI's 377 member companies represent 91 percent of life insurance premiums paid each year in the United States. Ninety percent of the annuity considerations, and 91 percent of the industry's overall assets.

Of those 377 members, 150 are small companies with assets of $2 billion or less. I would characterize our company, Protective Life, as a mid-sized company. We have about $30 billion in assets, which makes us a mid-size player in the United States life insurance industry.

But both large and small life insurance companies see regulatory modernization as something that must be accomplished in the near term if the life insurance industry is going to preserve its ability to provide consumers with the best products and services we can in order to provide the very essential products that we do provide to the American people.

We protect people against the catastrophe of dying too soon. We help them deal with all of the complexities of living too long and outliving your savings. We are a key part of the American financial services industry.

What is at stake here is all the more important given the fact that we have some 76 million baby boomers nearing retirement. With their life expectancies increasing, and the use of defined benefit pension plans decreasing, these American citizens will have to depend increasingly on the products and services that only life insurance companies can provide, products that guarantee lifetime income, long-term care, and lifetime financial security.

On one fundamental point, there seems to be general agreement, and Superintendent Iubba and I would, I think, agree with this, and that is that the insurance regulatory system has just not kept pace as the industry has evolved and become much more national in scope—even international in scope. And that substantial change to the current system is required.

Views differ, however, on how this situation should be addressed. The State regulators—and again, I want to be clear. We are not here to complain about State regulators. We have great respect for those who are our regulators. They do a good job. They work hard. Their intentions are very good.

But the problem is the framework that we are all operating under, the fragmented, 51 jurisdiction framework that we are operating. But the State regulators suggest that, while there are indeed problems, the appropriate solutions may all be found within the existing State-based system. And what is really needed at this juncture is simply more time for the States to act.

Others would suggest that the Federal Government should help move the remedial process along by enacting minimum standards that the States can then enforce. Let me briefly address these two approaches and perhaps suggest what we see as some issues, there.

We believe that State regulation will always be an integral part of the insurance regulatory landscape. That is why the ACLI and the life insurance industry remain firmly committed to working with the States to improve it.

That said, and notwithstanding the very good work that States have done advancing interstate compact for life insurance product approvals. The overall progress on regulatory modernization has been slow, and there is no realistic expectation that the many, many aspects of the State system that needs substantial improvement will be addressed in the foreseeable future.

That is why we strongly support the comprehensive approach to improving insurance regulation reflected in the legislation that Senators Sununu and Johnson have proposed. Having an optional Federal charter operating alongside a gradually improving State system of regulation seems to us to be the right way to go. And it parallels the successful dual chartering mechanism we see in the commercial banking sector.

We do not believe Federal minimum standards are the answer, either, as, by their very nature, they do not provide the uniformity our industry so desperately needs. Minimum standards establish only a baseline that the States would be free to add to as they see fit. In time, State-to-State differences in regulation would again be as prevalent as they are today and regulatory efficiency would be lost.

Again, we see the single uniform set of laws and regulations that would be established by Senate Bill 2509 holding out the best promise of achieving the level of regulatory efficiency that will truly benefit insurance companies, insurance agents, and, most importantly, insurance consumers.

Mr. Chairman, the ACLI member companies, both large and small, have carefully studied the issue of regulatory reform, and have concluded that Senate Bill 2509 is conceptually the best framework, the best approach to implement this much needed initiative.

The legislation establishes a Federal option in a prudent and appropriate manner by providing strong solvency oversight and consumer protections. It does not presume to reinvent the wheel, but instead draws heavily on the best existing State insurance laws and regulations and weaves them into a single, strong, and uniform system of national regulation. And, importantly, it leaves intact our State-based system of insurance regulation for those insurers wishing to remain regulated at the State level.

In sum, the bill provides a regulatory structure that best addresses the challenges of a highly mobile society. It would help ensure that insurance consumers remained accessed to the same coverage and protection, regardless of where they bought their policy or where they currently live.

Mr. Chairman, I again want to thank you for holding this hearing on this important issue, and sincerely thank Senators Sununu and Johnson for taking the initiative on insurance regulatory reform reflected in this bill. Thank you very much.

Senator SHELBY. Mr. Minkler.

STATEMENT OF THOMAS MINKLER, PRESIDENT, CLARK-MORTENSON AGENCY, INC.

Mr. MINKLER. Thank you and good morning, Chairman Shelby and Ranking Member Sarbanes and the rest of the Members of the Committee.

My name is Tom Minkler, and I am pleased to be here on behalf of the Independent Insurance Agents and Brokers of America, also known as the Big I, and its 300,000 members to provide our association's perspective on insurance regulatory reform. I am currently Chairman of the IIABA Government Affairs Committee, and I am also president of the Clark-Mortenson Agency, a New Hampshire-

based independent agency that offers a broad array of insurance products to consumers and commercial clients in New England and beyond.

I would like to begin by thanking Senator Shelby for holding this hearing on an area of critical importance to our Nation's consumers, how insurance is regulated. Unlike most other financial products, the purchaser of an insurance policy will not be able to fully determine the value of the product purchased until after claim is presented—when it is too late to decide that a different insurer or a different product might have been a better choice.

Because insurance is based on this promise, the consumer issues are much greater than in other financial sectors. It is clear that there are inefficiencies existing today with insurance regulation, and there is little doubt that the current State-based regulatory system should be reformed and modernized.

At the same time however, the current system does have great strengths, particularly when it comes to protecting consumers and facilitating local insurance markets. State insurance regulators have worked hard to make sure the insurance consumers, both individuals and businesses, receive the insurance coverage they need, and that any claims they may experience are properly paid.

State insurance regulation also gets high marks for the financial solvency regulation of insurance companies. These, and other aspects of the State-based system are working well.

Despite its many benefits, State insurance regulation is not without its share of problems. The shortcomings of State regulation fall into two primary categories. It simply takes too long to get a new insurance product to market, and there is unnecessary duplication in the licensing and post-licensure auditing process, particularly in regards to agent and broker licensing.

While there is agreement that State regulation needs to be fixed, there is disagreement about the most appropriate way.

There are three basic approaches. First, an ad hoc reform on a State-by-State basis. Second, the unprecedented establishment of a full-blown Federal regulation. And third, a pragmatic middle ground legislation to establish Federal standards.

The Big I is strongly opposed to OFC legislation, like S. 2509, the National Insurance Act. And in my written statement, I have laid out a detailed critique of the bill.

In the interest of time, I would like now to mention a few of those concerns. First, local insurance regulation works better for consumers, and a State-based system ensures a level of responsiveness to both the consumers and the agents who represent them. That could be matched at the Federal level by a distant Federal regulator in Washington, DC.

Second, the dual State–Federal system established by the NIA would be very confusing to consumers who may have some insurance products regulated at the State level, and others at the Federal level.

Third, the NIA would lead to additional regulatory burdens on agents, brokers, and, potentially, additional licensing requirements, and agents and brokers would have to become experts in both systems.

Fourth, by eliminating or drastically limiting regulatory review of policy language for the small, commercial, and personal lines markets, the NIA would leave consumers unprotected.

Fifth, bifurcating solvency regulations from the State guarantee funds could have disastrous implications for consumers.

And sixth, the NIA could potentially leave hard to insure risks with State insurers and cause a negative impact on State residual markets.

IIABA believes the best alternative for addressing the current deficiencies in the State-based regulatory system is a pragmatic middle ground. By using targeted and limited Federal legislation to overcome the structural impediments to reform at the State level, instead of a one-size-fits-all approach, we can improve rather than replace the current State-based system, and, in the process, promote a more efficient and effective regulatory framework.

There are only a handful of regulatory areas where uniformity and consistency are imperative, and Congress has the ability to address each of those core issues on a national basis. This is why IIABA supports targeted Federal legislation along the lines of the provisions of the Gramm-Leach-Blilely Act to improve the State-based system.

The proponents of OFC would have you believe that the optional Federal charter proposal creates a parallel universe of Federal chartered insurers, but leaves in place the State chartered system in pristine condition. This is not the case.

To take one example discussed earlier, OFC would, as a practical matter, force the State guarantee funds to accept and backstop Federal chartered insurers, and there is nothing optional about that.

This would mean unprecedented intrusion on State solvency regulation. The State system would be responsible for insolvent insurers, but could not regulate them to keep them from going insolvent.

Additionally, some OFC supporters have criticized the Federal tools approach because of enforcement concerns.

The reality, however, is that court enforcement of Federal preemption occurs regularly, and would occur under both the Federal tools approach and the optional Federal charter. As long as the Federal standards are clear, enforcement of these standards should not create more burdens on the court system than litigation arising out of the NIA. The only difference is that, under the NIA, a Federal regulator would receive deference to preempt State consumer protection laws and industry supporters of the NIA receive an advantage in court. Ironically, those same groups have criticized the targeted approach on both these grounds and have recently embraced this approach and legislation pertaining to surplus and reinsurance.

In conclusion, I would like to reiterate that while some D.C. interests have proposed an optional Federal charter as the only way to cure insurance regulation's ills, there is another way to go.

A rifle shot approach reforming the current system without settling it.

Targeted Federal legislation to improve the State-based system presents members with a pragmatic, middle ground solution that is achievable, something we can all work on together. It is the only

solution that can bring the marketplace together to achieve this reform.

Thank you.

Senator SHELBY. Mr. Beneducci.

STATEMENT OF JOSEPH J. BENEDUCCI, PRESIDENT AND COO, FIREMAN'S FUND INSURANCE COMPANY

Mr. BENEDUCCI. Good morning, Mr. Chairman, Senator Sarbanes, and Members of the Committee.

My name is Joe Beneducci. I am the president and chief operating officer of Fireman's Fund Insurance Company.

Fireman's Fund was founded in 1863 with a mission to support firefighters by donating a portion of our profits to families of deceased firefighters. Today we proudly continue dedicating a portion of our profits to support firefighters for safer communities. Our company focuses on providing specialized personal, commercial, and specialty insurance products nationwide.

Thank you for the opportunity to be here today to discuss insurance regulatory reform, a vitally important issue to consumers, Fireman's Fund, and the members of our property casualty insurance trade group, the American Insurance Association.

I would like to summarize my remarks this morning with three observations about the property casualty insurance market and the best way to regulate the market.

Number one, our economy is not static and continues to become more global every day. Consumer needs continue to expand and grow in conjunction with our economy. These evolutions have surpassed the current insurance regulatory environment's effectiveness and viability.

Number two, the current regulatory system inhibits innovation and actually perpetuates commoditization to the detriment of consumers.

And number three, a market-based optional Federal charter can benefit consumers by reforming regulation and encouraging innovation, while retaining the State regulatory system for companies who wish to remain there.

There is little disagreement that the current regulatory system is broken. Many proposals have attempted to deal with the inadequacies of the current system with literally decades of debate. Yet not one has come close to delivering a modern system that empowers consumers and focuses on real consumer protections. It is time for a new approach.

An optional Federal regulatory track-based on clear and more appropriate principles is the best way to foster innovation and achieve regulatory modernization that works for consumers, the industry, and our economy.

We strongly support the Bipartisan National Insurance Act of 2006, introduced by Senators Sununu and Johnson. Importantly, the act gives insurers the option of being nationally regulated while preserving the current State system for insurers who believe they can better serve policyholders within such a framework.

Property casualty insurance stands out in our free market economy because we are the only part of the financial services sector

still laboring under pervasive Government price and product controls. This form of regulation is rationalized as protecting the consumer.

In truth, it discourages and delays innovation, distorts risk-based pricing, and limits consumer options. This makes it difficult, if not impossible, for us to respond to increasing and evolving customer needs.

S. 2509 provides a better alternative. It enhances capacity by normalizing regulation and allows the marketplace, and by extension consumers, to dictate the full range of price and product choices. It establishes stronger refocused regulations to protect consumers as they navigate the marketplace and look to financially sound insurers for payment of covered claims.

In addition, an optional Federal charter would bring the best balance of needed uniformity for those choosing a national license, while respecting the decisions of others to remain under State regulatory authority.

Over the long term, a Federal regulatory option will effectively modernize industry regulation and empower consumers. By relying on the hallmarks of the free market and individual choice, S. 2509 recognizes our customer's changing needs and our insurers' desire and the ability to meet those needs in a highly competitive global market.

Without a doubt, everyone here supports a healthy U.S. insurance marketplace that serves and empowers American consumers. We appreciate, though, that creation of such a modern, dynamic market is not without challenges and that change can be unsettling for some. However, we believe the creation of an optional—let me stress optional—Federal charter is imperative to meet the needs of all types of consumers and insurers.

There is no compelling reason not to fully explore and debate this proposal.

Fireman's Fund and AIA look forward to defending and advocating an optional Federal charter that truly would serve consumers by fostering efficiency and innovation. We strongly support S. 2509 and thank Senators Sununu and Johnson for putting forth this thoughtful legislation.

Thank you, Mr. Chairman.

Senator SHELBY. Thank you.

Mr. White.

STATEMENT OF JAXON WHITE, CHAIRMAN, PRESIDENT, AND CEO, MEDMARC INSURANCE GROUP

Mr. WHITE. Good morning, Chairman Shelby and Ranking Member Sarbanes. I am Jaxon White, chairman, president, and chief executive officer of the Medmarc Insurance Group. I am a member of the Board of Governors of the Property and Casualty Insurers Association of America, referred to as PCI.

I am here today to present the association's views regarding regulation of the insurance industry. I appreciate the opportunity to appear before the Committee this morning.

PCI supports efforts to foster a healthy, well-regulated, and competitive insurance marketplace that providers consumers the oppor-

tunity to select the best possible products at the best possible prices from a variety of financially sound and responsible competitors.

PCI is composed of a broad section of insurers, including stock, mutual, and reciprocal companies. PCI represents large national insurers, regional insurers, single State companies, and specialty insurers. Our members write nearly 40 percent of all the property and casualty insurance written in the United States, including 49 percent of the Nation's auto, 38 percent of homeowners, 31 percent of business insurance policies, and 40 percent of the private worker's compensation market.

Our diversity means that PCI's positions on key issues such as regulatory modernization reflect a wide-ranging industry consensus and are crucial to the success of regulatory reform proposals at both the State and Federal levels.

My company, the Medmarc Insurance Group, has been in business for 26 years. I have served as the chief executive officer for the last 21 years. Our group consists of three property and casualty writers, one mutual company, and two stock subsidiaries.

Medmarc specializes in products liability coverage targeted primarily to manufacturers and distributors of medical devices and life science products. You would find us in that specialty category I just mentioned.

Our 2005 direct premiums written were just over $100 million and our net premiums were $66 million. We write business in all 50 States, making us subject to regulatory requirements in each jurisdiction.

PCI members share a common vision that competition and market-oriented regulation are in the best interest of the industry and the customers we serve. However, there is widespread agreement among members that the current regulatory system is too complex, too expensive, and too uncertain.

The key questions that all of us, insurers, regulators, State and Federal legislators, and consumers should ask are: One, what are the objectives and components of a fair and reasonable regulatory system?

Two, is it possible for the current State-based system to reform ourselves?

And three, if not, what can and should Congress do to facilitate meaningful reform of the current system?

In our view, the effective regulatory system should foster a competitive environment in which consumers can choose the highest quality products from a variety of financially sound competitors.

One of the inherent problems in the current system is the inconsistency of the regulatory environment from State to State. A patchwork quilt of rules and regulations adds up to a bureaucratic nightmare that creates delays and roadblocks for companies to expand into new States, that reduces the flow of capital to certain markets, and increases the cost of regulatory compliance and limits consumer choice.

Let me cite quickly a few examples. While most States accept uniform affidavits from directors and officers regarding their backgrounds, Florida does extensive background searches and fingerprints of all officers and directors and officers and directors of the

parent companies. Fingerprints are routinely rejected, causing some officers and directors to be fingerprinted multiple times.

The State of New York has an extraterritoriality provision that, in effect, requires a company to consent to be treated as a New York domestic company.

While some States recognize statutory deposits held in other States, some States require additional deposits in local banks.

Financial and market conduct examinations are often disjointed and inefficient and are so poorly coordinated that examinations in one State may often not be accepted by other States, adding duplication and cost.

But the core problem of the current system is the reliance by many States on antiquated price controls that impose barriers to market-based pricing systems. While other areas of reform are important, the elimination of artificial price controls is the single most significant element overshadowing all other reform components.

PCI urges you to place the highest priority on competitive market reforms as you consider regulatory reform proposals.

Twenty States still require that all changes, up or down, must be revised and approved before they take effect. The approval process can often take months. While many other States purport to have flexible approval procedures, many insurers feel it is safer to treat such regulations as de facto prior approval because of potential retroactive disapprovals.

Unfortunately, States have made little progress in enacting reforms on their own. While there are some positive developments to report, the overall prognosis for States to enact significant and systemic changes to the regulatory environment remains questionable.

On an aggregate basis, the regulatory landscape in the States remains virtually unchanged from the time Congress began to evaluate the need for regulatory reform 4 years ago.

PCI commends the members of this Committee for your commitment to improve the insurance regulatory environment. We urge you to thoroughly examine all of the alternatives, to move deliberately, and to consider the potential unintended consequences, especially in the area of increased regulatory cost of each reform proposal.

We believe the best place to start the debate, is to define the principles of a good regulatory system, determine what such a system should accomplish and then determine how best to correct the flaws in the current system.

PCI is looking at various models of business regulation here in the United States and abroad in an effort to build such a regulatory model. We will share this information with you as we consider various proposals to enhance the regulatory environment.

We share the goals of the Committee, to develop a more competitive marketplace, providing better availability of insurance and expanding coverage capacity for consumers.

We look forward to working with Congress, State legislators, and State regulators to modernize and improve the regulatory system.

Thank you.

Senator SHELBY. Commissioner, we will start with you, Commissioner Iuppa.

The financial structures of insurance companies are becoming, as we all know, increasingly complex as companies expand abroad and utilize sophisticated financial products such as derivatives and finite insurance.

Does every State have the technical expertise necessary to properly oversee such complex companies as part of the solvency regulation that you encounter?

Mr. IUPPA. Well, I certainly cannot speak for every State.

Senator SHELBY. I understand, but you are representing——

Mr. IUPPA. I understand that. But I think the way I would propose to respond to that is that the resources do exist within the State system and we actually try to take advantage of collaboration.

There are some States that are much stronger with regard to the resources that they have. But clearly, with regard to the changes in financial structure, the type of instruments that are being used by carriers we are intimately involved with, we are intimately involved with the development of new capital standards that are coming out of Europe and what type of effect they are going to have here.

So, I guess the short answer to that is I think we are well-positioned to deal with those financial issues.

Senator SHELBY. Do you believe you are keeping up with the marketplace?

Mr. IUPPA. It is impossible for anyone to keep up with the marketplace. The marketplace is the driver. We tend to react to the changes and the developments in the marketplace.

And I think if you look back over the 135 years, you will see that changes have been made, not only with regard to insurance regulation but other forms of financial supervision.

Senator SHELBY. Do you have any concerns that the States will find it necessarily difficult to hire the highly trained personnel needed to properly regulate a global insurance company. In other words, the marketplace works here. You have got to have sophisticated regulators, just like the Securities and Exchange Commission has to, and the Comptroller of the Currency has to, and the FDIC.

I mean, the world has changed a lot in the insurance market, and all financial products, as you well know. So do you believe the States—or do you have any concern that the States will find it difficult to keep up with that?

Mr. IUPPA. I think that there is a concern, in terms of competing with the private sector, for instance, for those experts.

Senator SHELBY. Sure.

Mr. IUPPA. There are certain limitations on resources that the States have. But again, there is also a willingness by some very smart, capable people, to respond to calls for public service, even if it is only for a short period of time.

Senator SHELBY. Mr. Johns, what impact does our State-based system have on the ability of companies to compete domestically and internationally, your company and others that you speak with?

Mr. JOHNS. Senator Shelby, the problems we face in dealing with this highly fragmented system of regulation are just immense. Our company started in Alabama in 1907, but now we do business

coast-to-coast. We have also had, at some times, an international operation.

We have companies headquartered in Birmingham. We have a company headquartered in Kansas City. We have a company headquartered in San Francisco.

Our strategy is to try to develop the best possible products we can for middle income Americans. One of our flagship products is just a term insurance policy, the most simple of all life insurance products. We have a very difficult time rolling out a new simple term insurance product because we have to go through a 50-State, a 51 jurisdiction process.

Senator SHELBY. What about the cost of dealing with 51 jurisdictions? Is that a concern?

Mr. JOHNS. It is very much a concern. We are examined constantly. We have different States coming in examining the same things over and over again in the market conduct area, for example. It is not uncommon to have two or three States in at the same time, reviewing us with respect to the same issues, all doing their separate examinations, which we have to ultimately pay for.

I could give you myriad examples of just the difficulty, the practical difficulties, of trying to comply with 51 sets of regulations that are, in some ways, consistent but that, in many important ways, that are very inconsistent. It is just a nightmarish way to have to do business.

It fit the world of 70 or 80 years ago very well, when most companies, including our own, was locally focused. But now that our focus is national, it is just out of step with the times.

Senator SHELBY. Mr. Minkler, how would you respond to the claim that our State-based system of regulation creates barriers to entry that insulate brokers and agents from competition? You have heard that before.

Mr. MINKLER. I would say, Mr. Chairman, that the issues on a State-regulated basis certainly can be addressed in a more pragmatic way to address, with the tools we have talked about.

For me as a practitioner, I am not inhibited by a competitive marketplace and the products that I can bring forward. However, I am challenged by multiple licensing requirements in the States that I do business in.

Senator SHELBY. What about the expense? I asked that question of Mr. Johns. What about the expense? You are an independent agent; right?

Mr. JOHNS. Yes.

Senator SHELBY. And you do business in how many States?

Mr. JOHNS. Approximately 14 States.

Senator SHELBY. What about the cost?

Mr. JOHNS. The cost to continue to update and relicense my staff is a substantial cost in both time and economic dollars. That is for sure.

Senator SHELBY. Mr. White, if price controls—I know people do not like to use that term—if price controls were removed on insurance nationwide, would most consumers see their insurance rates increase, fall or stay the same? What lines of insurance, in your judgment, are most likely to see their rates increase following the elimination of price controls if we did that?

Mr. WHITE. As a caveat, Mr. Chairman, we are in the commercial casualty business. You are referring to personal lines, but I would be happy to respond.

I think you will find a competitive marketplace, I like to quote our company, "Business goes where it is wanted."

In that situation, when you find that there are opportunities for smaller companies, as well as large companies, to compete on a level playing field without the barriers of the so-called price controls, that more efficient organizations can create lower rates.

I submit to you that homeowner's insurance would vary greatly throughout the country, as it does to some degree now. However, I think auto insurance is a different type of approach and you could see definitely lower rates there by being more effective in our underwriting skills. But many States require certain features of auto insurance that a consumer may not wish to buy.

And so, going forward, price controls, to me, smack of the past. And what we are looking for here, in regulatory reform, is the future.

Senator SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Gentlemen, I would like to explore the lay of the land on this proposal with you, in a sense to get a feel, as they say, of where you are coming from.

The first question I want to put is if there were a Federal—if there were an optional Federal charter, and therefore a Federal regulator, States now have a whole host of consumer protection provisions. Would you anticipate that the Federal regulator would be able to apply the whole range of State consumer protection provisions? Mr. White.

Mr. WHITE. In my judgment, Senator, I think that that system could be built from the beginning, and it could be a sound system that would incorporate the best of the State provisions and put that into a Federal system.

Senator SARBANES. Would you rule out any of the State consumer protection provisions for application by the Federal regulator?

Mr. WHITE. I would not rule out any such application if it made sense on a purely nationwide basis, and not necessarily limited to single State protectionism.

Senator SARBANES. Would you rule out pricing and rating consumer protection provisions for the Federal——

Mr. WHITE. I would rule those out because I believe the competitive marketplace will address those.

Senator SARBANES. You would rule those out right at the beginning; is that correct?

Mr. WHITE. I believe a competitive marketplace will take care of the need for, or eliminate the need for such of those boundaries.

Senator SARBANES. I guess the answer to my question is yes, you would rule them out; is that right?

Mr. WHITE. Yes, I would, sir.

Senator SARBANES. All right, Mr. Beneducci, your answer to that question?

Mr. BENEDUCCI. And the answer would be I do not see why a Federal system would not be able to support that level of consumer protection.

Senator SARBANES. So you would allow them to pass on rating and pricing; is that correct or not?

Mr. BENEDUCCI. From a rating and pricing standpoint, just to give you a perspective from one company's perspective, average filing for any particular price or form typically takes us anywhere between six and 9 months. It would be considered fast if it is less than 3 months and it is not uncommon to see it greater than a year or more.

If you look at the actual cost——

Senator SARBANES. If you get an optional Federal charter, so you come under the Federal regulator, in your perception, would the Federal regulator be able to regulate rating and pricing the way State regulators can now do? Or would that be knocked out?

Mr. BENEDUCCI. I do not think it would be necessary.

Senator SARBANES. Mr. Minkler.

Mr. MINKLER. Senator, I cannot imagine a scenario where a Federal regulator could do as effective a job on a State-by-State basis than our current system. Yes, there are things that have to be modernized there. But as far as rate and form go, every State has peculiarities. Every State has different pooling mechanisms. Every State has different needs. So I cannot imagine a Federal regulator being able to do the same kind of consumer protection job that is now existing.

Senator SARBANES. Well, of course, Mr. White would not let them do the job at all, as I understand it, in this area. Mr. Johns.

Mr. JOHNS. Senator Sarbanes, that is not a centerpiece issue for the life insurance industry, since our pricing is not generally regulated for life insurance annuity products by the States, and rating is really not a centerpiece issue for us.

Senator SARBANES. You would, I take it, put the life insurance industry in one category, as opposed to other forms of insurance; is that right?

Mr. JOHNS. The ACLI supports a dual system. We are supportive of both life and property and casualty——

Senator SARBANES. Do you support preempting States?

Mr. JOHNS. We think there probably are some issues where a Federal regulator should have preemptive power. But when you get into the sensitive issues of consumer protection, we think there is very legitimate area for discussion there.

I would like to echo the comments of Senator Sununu, which is that that piece of legislation is sort of not completely formed. I think it would be very appropriate for Congress to really build a very strong system for consumer protection that would take the best of the State system, leave to the States things that are best left to the States, but bring to the Federal regulator the things that are best placed there.

Senator SARBANES. Let me ask you all this question, why should the charter be optional? Why should the entity to be regulated be able to choose, on its own, its regulator and therefore presumably be able to arbitrage the regulatory framework?

Why don't we start with you, Mr. Iuppa, and we will go across this way.

Mr. IUPPA. OK. Well, the interesting thing is even though it is called an optional Federal charter, I do not think it really optional. I think A, the issue of regulatory arbitrage certainly comes into play——

Senator SARBANES. Let me ask you this question. How many States have joined the Interstate Insurance Product Regulation Compact?

Mr. IUPPA. We now have 27 States, which represent around 42 percent of the market. We held our inaugural meeting just a few weeks ago, in June, and expect to be operational in early 2007. And again, using national standards.

So for those companies that are in those 27 States, and we anticipate many more joining, they will have a single point of filing. They will have national standards in those compacting States to have their products measured against.

And the other thing to keep in mind is the companies and the industries had significant input into the drafting of those standards over the last 18 months, as well.

Senator SARBANES. So, you have 27 States that have joined, and another 10 or 12 that are considering joining? Is that correct?

Mr. IUPPA. I think the number is probably even higher. As you probably recognize, Senator, coming in January 2007 is effectively a new legislative season for all the States. So we are anticipating a significant number of the remaining States to introduce legislation.

Senator SARBANES. Let me go back—thank you.

Let me go back to my question and just come across the panel real quick, because my time.

Mr. Johns.

Mr. JOHNS. Senator Sarbanes, we do not see the optional Federal charter as presenting an opportunity for regulatory arbitrage. We point to the banking system, where we think you have very healthy systems, both State and Federal, that operate in parallel.

Senator SARBANES. Now, we are concerned about that. The OCC has just preempted a number of consumer protection provisions applied by the States to federally chartered banks under the OCC.

Some banks are now shifting from State regimes to the OCC regime. There is some suspicion that they are doing it just to boost their membership and their fees and the jurisdiction. But there seems to be a real problem there of regulatory arbitrage.

Mr. JOHNS. Senator, I am well aware of that issue and I would suggest——

Senator SARBANES. Did I misstate it?

Mr. JOHNS. No, sir, you did not. But I think you have the opportunity to build the system that Congress wants here. I think you have the opportunity to—I think it is a mistake to confuse the concept of an optional Federal charter with the problems that could be created if the regulatory structure is not well formed.

I think those are two separate issues. I think the consumer protection provisions in the draft legislation are not fully fleshed out yet. I think there are statements in there to suggest the direction is toward very strong consumer protection. There is no reason that

you cannot have better consumer protection under an optional Federal charter than you have under the existing State system.

Senator, I would like to say one other thing. While we applaud the interstate compact and think it is a very good step forward, and the ACLI has worked hand in glove and in cooperation with the NAIC, it has been 7 or 8 years in the making. It does not cover even half the population, yet. It only addresses one of at least a dozen important issues.

And it is daunting to think, if we have to go down that path, how long it would take to achieve true reform through this kind of approach. I think the compact, in some ways, illustrates the problem as much as the opportunities within the State system.

Thank you.

Senator SARBANES. Mr. Minkler.

Mr. MINKLER. Senator, our position is we oppose a Federal charter of any sort, whether optional or not.

That being said, I think that an optional charter at this moment would become, for most of us, it would not be optional over time. We would be forced into a federally regulated program for a lot of reasons that I have indicated in my earlier testimony.

So, in that case, we are not in favor of an option.

Senator SARBANES. Mr. Beneducci.

Mr. BENEDUCCI. Senator, as you have heard some of the different opinions on this topic, I think it would be very difficult if this was a mandated approach to actually have passed.

So, in recognizing the different opinions that sit at the table, this provides the best alternative for both sides to actually get what is necessary.

Senator SARBANES. If it could pass, would you prefer to have it mandated?

Mr. BENEDUCCI. No.

Senator SARBANES. Why not?

Mr. BENEDUCCI. Because I still do not feel by having an optional Federal charter provides those that believe that system is best supportive and can actually help consumers with more innovative products and also streamline efficiency.

For those that actually feel otherwise, that the State system is still supportive, that would still be up to them and it would be their decision.

Senator SARBANES. If I were the Federal regulator, do you think I could get people to join if I did a pretty sizable preemption of State consumer protection law?

Mr. BENEDUCCI. I do not know. I could not answer that question, Senator.

Senator SARBANES. That is pretty hypothetical.

Mr. White.

Mr. WHITE. Senator, the optional Federal charter should remain optional. However, in the sense of smaller companies, and here we distinguish personal lines and commercial lines, as I said earlier we are commercial lines.

Our policy holders can be sued in third-party liability in any of 50 States. By accident of where they happen to have their corporate headquarters they get a certain style of regulation. So we

might have four or five different types of appearances and policy forms for our policy holders.

So for a smaller company like us, 62 employees, about $65 million in revenue, the optional Federal charter would be an enhancement if it contained the right features. Not necessarily, as you said earlier, it would not be perfect in all respects for consumer protection. But I believe that a Federal regulator would, indeed, have those considerations before him or her.

Senator SARBANES. Mr. Chairman, I have gone over my time.

Senator SHELBY. Senator Sununu.

Senator SUNUNU. Thank you, Mr. Chairman.

Mr. Minkler, you just indicated that you thought companies would be forced into the Federal charter over time. Why would that be?

Mr. MINKLER. Senator, let me speak first for brokers and agents like myself. For example, if I understand the language of the bill correctly, while I think it makes a good faith attempt to streamline the licensing procedures, currently if I chose, for example, to be a State-chartered agent—we are not talking about the carriers now, we are talking about an agent—and I then wanted to do business with a federally chartered carrier, it would appear that the national regulator could impose mandates on me to actually become federally chartered and/or to——

Senator SUNUNU. Absolutely not. Under the legislation, if you are licensed in the State, you are able to sell any Federal product, period, in that State.

Mr. MINKLER. Correct.

Senator SUNUNU. And you may so choose to get licensed in other States, as you are. You said 14 States. So that certainly is not the case.

So why would you be required, or why would any participate in the industry be required to take the Federal charter?

Mr. MINKLER. While I agree that it appears that by being licensed as a State chartered agent I would have the ability to contract with a federally chartered carrier, it appears in the language to me that the Federal regulator, the national commissioner if you will, would still have oversight of my conduct with that carrier and, indeed, could lead me to have to receive a Federal license.

Senator SUNUNU. The national regulator would certainly have oversight over the federally licensed products, but that by no means would give them power to force you to accept or to apply for a Federal license.

I think that is a misreading of the language.

Ranking member Sarbanes raised a couple of interesting points and questions about consumer protection, and I think that is an important issue and one that we are going to continue to discuss here. I just want to highlight the consumer protection aspects of the bill.

The legislation does set up a division of consumer affairs and a division of insurance fraud. It makes insurance fraud a Federal crime. We have also established an ombudsman, which was a specific recommendation of Senator Johnson, to act as a liaison between the regulator and people that might be adversely affected.

To be sure, there may be other thoughts, ideas with regard to consumer protection. But those are the key elements that we have included in the legislation to deal with this issue.

I want to take a moment to eat up some of my time here to address a concern that has been raised. It was raised in some of the testimony here and in other venues. I think it is worth addressing. And this is the idea of consumer confusion, that this is a bad idea because consumers will be confused. And I absolutely reject the idea, in just about any field of Federal action, that consumers are too stupid to understand the regulatory procedures or processes.

And it is done in many other areas where people do not like legislation so they say this is going to be terrible, the consumers will be confused. That is a simplistic way of saying that consumers are dumb. And I patently reject that suggestion.

We have State chartered banks and federally chartered banks. Consumers do not know and they do not care whether they are a bank, whether they are a small business or a big business doing commercial work or consumer banking, they do not care if it is a State chartered bank or a federally chartered bank, or a non-bank for that matter like a credit union.

We have, in telecommunications, cable, phone service, cellular service. We have Federal regulations. We have State regulations. We have local regulations. And I will maintain that those regulations in telecom, just like in insurance, raise cost, stifle innovation, limit product introduction. But they do not create consumer confusion to the extent that consumers are not able to take advantage of cellular service or cable service or broadband service.

We have testimony here that agents are registered in 14 different States. I know agents that are registered in two dozen different States. Now that is confusing. That is tough. I certainly think that agents are intelligent enough to handle that. And I also think that consumers are not too confused to take advantages of the quality services offered by those agents.

So, I think we need to get away from the idea that setting up a dual charter system, or passing the so-called rifle shot approach, which also would effectively create a dual system, some Federal regulation, some State regulations. It is not going to be too much for consumers to handle.

To that point, there has also been the suggestion that the optional charter is one size fits all. It is anything but one size fits all, because it is truly an optional charter.

Now, an individual agent or underwriter may feel that the State does a better job in their regulation, that they are more efficient, that the State regulatory structure brings them closer to their customer, and may therefore choose to continue to operate under a State system. And that is fine. I think that is just fine.

But the so-called rifle shot approach, make no bones about it, would preempt the actions of every participant in the market in those areas that the rifle shot chose to address.

The proposal circulated in the House preempts every participate in every area that it regulates. We simply do not do this in this legislation.

So, you may have concerns that Senator Bunning expressed, and I share, that we not create expensive bureaucracy and we not act

in a duplicative way, and we not engage in action that would result in unintended consequences. And so you may say we should not do anything in this area.

But let us not suggest for a moment that proposals circulated in the House are not preemptive. They are extremely preemptive in those areas where they choose to take action.

I do want to—I know I have run over—but I do want to ask one series of questions with regard to desk drawer rules, which I think Mr. White included in his written testimony. I found this intriguing and would just ask that Mr. White describe a bit for the Committee what are desk drawer rules? And if you could just give a couple of examples to illustrate that.

Mr. WHITE. Certainly, Senator.

It is a euphemism that is used in the industry for some time now, having to do with the fact that there are a stated set of requirements for a form approval or a rate approval. And yet you run into interpretative situations that do not allow that to go forward. It essentially is a hold that is placed on the application.

And as you may know, there are no suspense rules when it comes to rate and form filings. It is up, individually, to each State, to address those. We have run into this from the point of view of whether the rates are adequate.

Now, if our actuary, our consulting actuary, and our marketplace assessments says that our rates are adequate and then we have to deal with an individual who may have 2, 3, or 5 years of experience, very little experience in our line of business which is highly specialized medical technology products liability, we find that that individual can stop our rate filing because they feel that there is some deficiency in there but they cannot really pinpoint that deficiency. That is an example.

Senator SUNUNU. So, it is a deficiency that is not contained in any specific promulgated regulation or legislative language?

Mr. WHITE. No such thing. It is a interpretive matter on the part of the individual reviewer.

Senator SUNUNU. There is a system, a delivery system for filings out there called SERFF. Could you comment on that generally? But my question is does that electronic system do anything to address these somewhat ad hoc desk drawer rules or underlying prior approval requirements?

Mr. WHITE. I applaud the NAIC for pioneering that. It has been around for 4 or 5 years now and there are States that use it.

It tends to appeal to larger companies, not companies of our size, which are smaller. And it is a fairly, what you would call a “me, too” type process. Thus, you avoid the issues of having to go through a protracted process when the document and the form looks essentially the same as a competitors.

In our case, the desk drawer rules then, we do not use the SERFF system because we do not feel it is efficient for our purposes because we want particularity and specificity in our rates.

The desk drawer rules do indeed come into play with us and we eventually prevail. I should not say prevail. We are eventually approved. But one has to go along with whatever the interpretations are over a period of 30, 60, 90 days until there is an accommodation reached.

Senator SUNUNU. Thank you, Mr. White.

Thank you, Mr. Chairman.

Senator SHELBY. Senator Johnson.

Senator JOHNSON. Thank you, Mr. Chairman, Members of the Committee.

Following up a bit on Senator Sununu's question, Mr. Iuppa, how frequently used or how ever present are desk drawer rules? Does anybody know?

Mr. IUPPA. I think the answer to that is it is considerably less than it was say 5 or 10 years ago. We have gone, as part of the SERFF system that was just referred to, not only is there an electronic platform for filing rates and forms, but we have put together product matrixes and product locators so that the companies know beforehand what the statutory requirements are for the filing of a particular product.

So they know going in, to eliminate the desk drawer rules. We have been incredibly vigilant in trying to do that.

The other thing I want to point out is with regard to SERFF, there are about 1,800 companies out of the 6,500 companies in the United States that do business here who are making use of SERFF. I think the average turn around time is about 23 days for product approval. The cost per filing is considerably less than it is on the paper filing.

And what really strikes me is that there are still companies that still use paper filings to insurance departments, even though they can make an electronic filing in just about every department.

Senator JOHNSON. Somewhat less than a third of the companies have chosen to use the SERFF.

Now the NAIC places a lot of emphasis on acting uniform laws and regs among the different States. To date can you tell me how many NAIC model laws and regulations have been implemented uniformly by the different States and, in your case, by the State of Maine?

Mr. IUPPA. Well, I believe there is something like 300 or 400, possibly more, model laws and regulations that have been adopted over the years. I certainly am not going to sit here and say that every single one has been adopted in its entirety by the States.

But what I would point to, for instance, in the area, of financial oversight, which is a key aspect of consumer protection, that essentially across the country in all 50 States, you have the same types of requirements. You have effectively the same laws or substantially similar laws for financial oversight.

And that is manifest through our accreditation program, which has been in place now since the late 1980s.

Senator JOHNSON. Mr. Johns, critics of the OFC proposal are concerned that it may be optional in theory, but in practice competitive pressures may force all insurers into the Federal system in short order. How do you respond to that?

Mr. JOHNS. Senator Johnson, I doubt that will be the case. I am very skeptical about that argument.

I think that there are many insurance companies in this country that are really locally focused. There are many that do business only within one State or only one or two States, and I think they will find it attractive to remain within the State system.

I think the companies that will opt to go into an optional Federal system are those whose business, like ours, is truly national in scope, where there are efficiencies when you are doing business in 51 jurisdictions to have one consistent set of rules.

So, I really am very skeptical of that argument. I do not foresee that happening.

Senator JOHNSON. Mr. Beneducci, one of the issues that Senator Sununu and I had to discuss early on was the belief of some that a life only optional Federal charter is easier to do and it might make more sense for now. How would you respond?

We obviously have a more comprehensive life, property and casualty bill here. How would you respond to those who suggest a life only optional Federal charter is the better route to go?

Mr. BENEDUCCI. Senator Johnson, unfortunately, sometimes the easy way is not the best way, and I would not see any different outcome or need for someone that is a life insurance customer versus a property casualty customer. Both should be entitled to the same level of efficiency and both should be entitled to the same level of innovation and products.

So, I do not see there being a difference one way or the other.

Senator JOHNSON. Mr. Johns, how do you respond to the argument that consumers are better served with a State or local regulator, particularly in terms of consumer protections? Could you share some thoughts with us on that?

Mr. JOHNS. Senator Johnson, I offered some thoughts in response to Senator Sarbanes' question, but I will add a few more.

I start from the premise that we have the opportunity here to build the best possible consumer protection system we can. We can take from the State system the best ideas that are out there. That is point one.

Point two is that the State system, though I think our State regulators labor heroically to look out for the interest of consumers, the system is fragmented and diverse and different, it is just almost impossible to work within it to the common goal of consumer protection.

And I really honestly do not think that the locale of the regulator is really the determinative issue in terms of the quality of consumer protection. I think it matters little whether, if you have a consumer complaint, you pick up the telephone and call Montgomery, Alabama, or, under Senator Sununu—in your bill, you have regional consumer offices set up so the consumers could have sort of a local feel to the service if that is what they desire to do.

But I really do not think—I think that is sort of a red herring issue, that just because you are on the ground local that you do a better job of consumer protection.

Senator JOHNSON. I see my time is about expired, but let me fit one question in here, for Mr. Minkler. Thank you for your testimony.

In a recent speech to a State agent group, your organization asked who these agents thought would have the ear of a new Federal regulator. Do you believe that regulation is based on an agent or agency having the ear of a regulator? Should not regulation be based on consumer protection and fair, consistent, and impartial

treatment of insurers and producers instead of on personal relationships or political connections?

Mr. MINKLER. Senator, did I hear you say the ear of?

Senator JOHNSON. Of the regulator.

Mr. MINKLER. I actually do believe that it is imperative and much more consumer friendly to have a local representative in place. This is not to talk to political patriotism. This is to talk to the knowledge that a local regulator has of his or her State.

In my State, for example, we will have, our regulator will get calls regularly in the wintertime about backup of storm damage, ice and snow. A regulator in Texas would never have that call.

A Federal regulator in D.C. would have a difficult time to know the intricacies of each State and how to best respond to that.

We have a mature regulatory marketplace now. We have approximately 13,000 regulatory personnel on the ground that works very effectively. To have that same type of consumer protection where a consumer could feel best served would indeed mean replicating that in that type of scope again.

Senator JOHNSON. Thank you, Mr. Chairman.

Senator SHELBY. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

This is for everyone except Mr. Iuppa.

Mr. IUPPA. Iuppa.

Senator BUNNING. Iuppa. Are you all operating profitably presently?

Mr. JOHNS. Yes.

Mr. MINKLER. Yes.

Mr. BENEDUCCI. Yes.

Mr. WHITE. Yes.

Senator BUNNING. The four of you. All of your agencies are? Those you represent?

Mr. MINKLER. Yes.

Senator BUNNING. I just wanted to make sure that was the case, in case that there was a driving need for some kind of new regulations so that you could operate more profitably.

Mr. Beneducci, this question is for you, but Mr. White, or any other witness should feel free to answer.

If given a choice to be federally regulated, I would assume that insurers newly positioned in a national marketplace would be able to cover all risk nationwide, such as natural disasters, flood insurance, earthquakes.

Would you be able to guarantee the availability of this insurance to all consumers in all regions of the country?

Would you support legislation that requires companies to offer things like flood insurance as a condition of a Federal charter?

Mr. BENEDUCCI. Well, there are a few questions there to address. As far as a new entrant to the market, I think that is going to depend largely on what their expertise is. I would not want to forget the responsibility of a carrier to actually focus on products that they have an expertise in to be able to provide to the market.

Just because the market would be open does not suggest every company would actually be insuring every coverage in every State for every consumer.

Senator BUNNING. The Federal regulator could possibly say that if you are going to sell in all 51 jurisdictions, you should have to provide X coverage, whether you are on the Gulf Coast for hurricane or water, or whether you are in California, or even in Kentucky for that matter, for earthquake damage, because we are on a fault line.

Mr. BENEDUCCI. Senator, it does speak to, though, a carrier's expertise in a particular coverage. And that is really where different carriers will focus on different coverages.

I think it would be wrong to assume that a carrier should just provide coverage for the sake of making it available if they do not have expertise to do it. It speaks to the responsibility of the company.

Senator BUNNING. Mr. White, on the same question.

Mr. WHITE. Senator, financially and mechanically, I do not think that that could work. From the financial side, many, many insurers in this country are well under $100 million in financial surplus. They might indeed have a national opportunity, but they could never expand into multiple lines of insurance.

Mechanically, most of us depend on reinsurance and I cannot even speculate how many reinsurers would be interested in reinsuring a newly chartered Federal company that has no experience in underwriting earthquake or flood. So mechanically——

Senator BUNNING. That is generally why we have a Federal program to do just that.

Mr. WHITE. Indeed, because that is what we call the moral hazard or other versions of that same genre, which says that you only buy the insurance when you need it. That is not the purpose of the way that we structure our company's products.

Senator BUNNING. OK.

Mr. Johns, it is clear that you support legislation that would create an optional Federal charter for both life and property and casualty insurance.

Mr. JOHNS. Yes, sir.

Senator BUNNING. There are differences between property and casualty insurance and life insurance that may justify different treatment.

Do you agree that there are such differences? And would you support a life only option Federal charter if it were introduced?

Mr. JOHNS. Senator Bunning, we are aware that there are very clear differences in the life insurance industry and the property and casualty industry. However, we think we have operated under the same regulatory framework in the States for 150 years. We think that could be accomplished at the Federal level, as well.

Our trade association position is that we do indeed support a dual system.

Senator BUNNING. This is for anyone.

We cannot ignore our experience with flood insurance as an example of Federal involvement in insurance and customer service. FEMA is still resolving claims, and as of yesterday they were just being sued, for several years ago. We can expect thousands of more disputes from last year's hurricanes. I do not see why a Federal insurance regulator would handle disputes any better than FEMA has.

Do you believe that a new Federal regulator would be more effectively and efficiently responsive to the needs of consumers that the States currently do?

Could a uniform Federal standard with State regulation create the same efficiencies but provide better consumers services? Anybody?

Mr. MINKLER. Senator Bunning, I would say that there is no evidence that a Federal regulator would do a better job than a State regulator in any line of business. Flood is an excellent example, but I would be concerned about any other of myriad of coverages that a consumer would face.

We talked earlier about the lack of regulatory form in the NIA bill. I would be concerned if a carrier decided that they did not want to offer a standard coverage that is being offered to consumers today, that they could just opt out of that part of that. I do not think consumers are well served to move away from a regularly acknowledged form of coverage, for example homeowners, where a carrier could say we choose not to participate—since we do not have to have a regulated form, we choose not to participate in windstorm, for example.

So I think that would be a disadvantage for a Federal regulator.

Senator BUNNING. As you well know, this Committee is considering the renewal of the flood insurance program, and we have a deficit of about $25 billion in that insurance program right now at the Federal level.

I am sure that you are aware that you could be involved in that deficit right now if you had underwritten what you did not underwrite and the Federal Government was required to underwrite when no private sector insurer would. So I want you to be aware that what might look really good to you might put you in jeopardy in some places in the long term.

Mr. BENEDUCCI. Senator, if I could add, I think one of the reasons that we face that situation is because of some of the regulation in terms of what can be charged for flood and the terms by which it needs to be provided has actually restricted capacity to insure that.

Senator BUNNING. We are having that dispute in the courts right now. As you well know, in Florida, FEMA is fighting whether it was hurricane damage or water damage.

And if you lived in Naples, Florida, and you had a home and the hurricane went through, whether the hurricane damaged your house or whether the water damaged your house, that is in the courts right now being disputed.

I just want you to know that, if you were writing that insurance, what you could be up against in the courts right now, privately.

Mr. Chairman.

Senator SHELBY. Thank you.

Senator Carper.

STATEMENT OF SENATOR CARPER

Senator CARPER. Thanks, Mr. Chairman.

To our witnesses, welcome. It is good to see all of you today. Thanks for joining us and for your testimony and responses to our questions.

Several of the questions I had planned to ask and to raise with respect to optional Federal charter have been asked, you have answered them, so I am going to move on to other issues that I do not believe have been covered.

The first of those involves our representation at international forums where we may or may not be participating, and speaking with one voice on issues, particularly in the insurance side of financial services. I want to talk a little bit about that.

I want to have us focus a little bit on TRIA. As we look toward trying to come up with a more permanent fix before the end of next year.

First, let me say, financial services industries, as we all know, is an international industry today. Our major banks and security companies have a substantial presence, not just throughout our hemisphere but all over the world. And as such, their respective regulators, whether they be the OCC, the SEC, and so forth, all have counterparts in other major countries.

They meet. They negotiate standards that are applicable to companies, not just here but throughout our globe. I think a prime example of this is probably the Basil Accords that set international capital standards for banks.

This picture is in sharp contrast to the insurance industry. There is no single voice at the Federal level to represent U.S. interest in international communities and forums.

I just want to ask our witnesses today to comment on this, if you would, and to ask if you think that the lack of a Federal voice harms U.S. interests? Maybe you think it is helpful. I would welcome your thoughts.

Mr. Iuppa, I like your name a lot, so I am going to call on you first, just so I can say Iuppa a couple of times. Welcome. Why don't you lead us off.

Mr. IUPPA. Thank you very much.

I guess I would respectively disagree with some of your premise from the international perspective. On the regulatory side, supervisory side, we are very much represented internationally.

In fact, in addition to being president of the NAIC, I chair the International Association of Insurance Supervisors, which is an international standard setting body for insurance supervision.

I participate at the Financial Stability Forum alongside of the Fed, the Treasury, the Bank of England, Bank of Japan, and so forth. We are actively involved in the development of capital standards, the new capital standards in Europe, Solvency II which is more of a risk-based approach similar to what we did here in the United States about 20 years ago.

So I think there is very much a U.S. voice in that environment.

Senator CARPER. OK. Thanks.

Mr. Johns.

Mr. JOHNS. Senator Carper, I am surprised you have not given me a hard time about my name, John Johns. You have picked on Superintendent Iuppa.

Senator CARPER. What is your middle name?

[Laughter.]

Senator CARPER. Maybe we should not go there.

Mr. JOHNS. Thank you. But in response to your question, I think it is very much an issue for our industry, the fact that we are so fragmented in this country and that we have no spokesperson representing at the Government level here in Washington the interest of our industry.

I will point out again that we are a $4.5 trillion industry. We represent about 10 percent of the money invested in the debt capital markets in the United States. We are a huge force, not only in the United States but throughout the world, in economic development because of the investment decisions we make.

Our president of our trade association, Governor Frank Keating, recently returned from a trip to Japan and South Korea where he was advocating that they open up their markets to U.S. companies. What do you think they said? They said, well, you have got these incredible trade barriers in the United States. You have this 51 jurisdiction insurance system our companies find completely confusing and befuddling and a huge barrier to entry into our markets.

So it is very difficult for us to go abroad and advocate reform, modernization, improvement in their systems when they come back and look at ours and say your system, from our standpoint, is a big trade issue.

So I think you are right on with your comment, sir.

Senator CARPER. Thank you, Mr. Johns.

Mr. Minkler.

Mr. MINKLER. Senator, we have heard that there is a need for oversight from a Federal regulator for tax issues, trade policy development, that type of thing.

In conjunction with Mr. Johns' statement, while I am certainly not an expert in this area, it is my understanding that one of our main trading partners, the European Union, actually uses a Federal tools approach that we are proponent of here today.

While having a voice at the Federal level in the form of a liaison for tax, trade, and policy development, we would be in favor of that. But not in the form of a full blown regulator.

Senator CARPER. All right, thanks.

Mr. Beneducci.

Mr. BENEDUCCI. Yes, Senator. I would agree with Mr. Iuppa's comment, in terms of us actually being represented and having an international voice.

However, what troubles me is the message contained in that voice is sometimes very contradicting.

We actually share a very positive tone internationally with how open our market is and how accessible our market is. But yet, at the same time, it is extremely cumbersome to operate within.

And just on behalf of one company here, to give you a sense, just simply to go through a filings process for a company like Fireman's Fund, we average more than 2,000 filings a year. And out of all of those filings, roughly 350 of which are actually spent with true new products. The reason for that is our internal market here, our U.S.-based system, actually speaks to more conformity than it does to creativity. Very simply because you are going to approve forms that you are more familiar with.

And, from a company's perspective, we will gravitate more toward them because you are not going to spend time with product that you cannot get approved.

So I think there is a contradicting message that we send.

Senator CARPER. All right.

Mr. White, last word.

Mr. WHITE. Senator, we do not find it particularly disturbing that there is not an international body that would look after our interest. As a small a company as we are, we have a substantial stakehold in the state of Israel. Our policyholders conduct clinical trials in Western Europe, and we have liaisons with companies there.

So we do not find that an overarching body would achieve much for us. It is the quality of the service and the ability to deliver that service at a point in time.

Senator CARPER. Good. Well, thank you to each of you for your responses.

Mr. Chairman, I have another question I could ask here but I am going to submit it for the record, with respect to the need for us to figure out what we are going to do after the end of next year with respect to TRIA. I am going to submit that, and if you could be good enough to respond for the record, I would be most grateful.

Thank you all.

Senator SHELBY. As all of you know, Senator Carper has unique experience of congressman, Governor, and of course we are glad he is with us in the U.S. Senate today. And he will cover a lot of ground.

Senator Menendez.

Senator SARBANES. Senator, could I just observe that the TRIA extension we passed included a requirement that the President's Working Group on Financial Markets, in consultation with the insurance commissioners and the insurance industry and representatives of the security industry and policyholders, analyze the long-term availability and affordability of insurance for terrorism risk and report to the Congress no later than September 30 of this year.

I have to confess I have not followed it. I do not know what the working group has done so far.

Senator SHELBY. We will find out soon. Thank you, Senator Sarbanes.

Senator Menendez.

STATEMENT OF SENATOR MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman. I appreciate the panel's testimony.

In pursuit of reading some of your testimony and hearing some of your answers, I have a series of questions.

First, Mr. Johns, on page eight of your testimony, you refer to the Federal regulatory option available under S. 2509 as at least as strong as the better, if not the best, State system.

Which one is that?

Mr. JOHNS. Senator, it is hard to say, because they are all so different. I think every State——

Senator MENENDEZ. How can you make the statement that it is at least as strong as the better, if not the best, State system if you cannot define what the best State system is?

Mr. JOHNS. Well, there are many good State systems, and I am unable to identify the very best. But I do think you have the opportunity, the framework of this legislation, to take the very best aspects of the best States—and there are many of them that are very good—and create a superior system. That is the point we are trying to make.

Senator MENENDEZ. Yes. I think your statement, however, is a little overreach, based upon what you say there, unless you can define for me what is the best State system.

Let me ask those of you who support the Federal charter effort, what specific benefits will you be able to offer consumers? Many of you, in your answers, have talked about consumers. Well, what specific benefits will you be able to offer consumers that you cannot provide under the existing regulatory system.

Mr. BENEDUCCI. Senator, if I could answer that just to share with you—about 3 years ago, I will give you a specific example. About 3 years ago we did some customer research with a number of our commercial customers. And we asked them flat out what is the most important thing to you as a consumer of insurance? And if we could provide it, what would it look like?

The response from our customers was our data. We need you to protect our data. That is what we need help with. And certainly, in an evolving economy and global marketplace we all know why, in addition with technology, why data is so important.

Well, what we started to do was try to create a product and service whereby we would actually create an online data backup facility for our customers. We worked with a third party to try to create such a product.

We then took it to different States to test how that might be approved and what we would need to go through. And we received responses anywhere from it would not be approved because it would be considered tying of a financial product to this would be considered rebating in other States to it would be considered well, we will let you do it but we are going to be very strict in terms of the pricing that will apply, all the way to we will not approve it unless you actually have loss experience.

The reason for the support for consumer, and they have specifically asked for it, they need protection for data. And the way that will typically take place today is we will provide them a limit for their electronic data processing media. Then when we have a loss, we will cut them a check but more than 80 percent of those customers that are hit with a severe loss will not get back up and running. And the consumer loses.

Senator MENENDEZ. What else?

Mr. BENEDUCCI. I could give you other examples in terms of another service very similar to this, where we have actually looked at a service for providing employee screening for customers and for our commercial customers, the process that they go through to actually hire new employees and background checks and drug testing.

Again, we have another service that we have worked with another third party, the very same type of response. And these needs are actually generated not by us but by the consumer to say we could use products and services that would help us in these areas.

Instead, what the industry conforms to is what would get approved through the filing process rather than what the products are that actual consumers need. So there are an infinite number of examples.

Senator MENENDEZ. Let me ask, several of you in your testimony have talked about the inefficiencies and how that costs consumers. Could you tell me, could you quantify that in terms of if the Federal charter eliminates all those inefficiencies for you, would you drive down the cost of the product? Or would we be increasing the profit margin? Whoever wants to answer that.

Mr. BENEDUCCI. I will take a first stab at that, just to give you a perspective, again from Fireman's Fund today, if you just took a look at the filings that we go through, on average that is a little bit higher than $15 million a year that we spend just on the filing side.

And we have reached a point where the cost for filings is actually now in excess of the amount of dollars that we spend for external claims adjusters in our marketplace.

To answer your question, what would happen with those dollars? What I would like to do is actually shift them to have more claims support on the ground for consumers to be able to provide better service.

Senator MENENDEZ. The price would not necessarily go down?

Mr. BENEDUCCI. I think the price would be more consistent with the value provided from an insurance product. Some would be more commodity based for companies that produce lower cost products. Other products would be much more value based, based on the true value as the examples that I gave you to the end consumer.

Mr. WHITE. Senator, I think you might want to distinguish between a mutually owned insurance enterprise and a stock insurance enterprise.

We are a mutual company. Our reason for building is to build financial surplus and to have a bulwark of protection for our policyholders.

Yes, we are profitable, as we all responded to Senator Bunning earlier. But those profits, in our case, go to build the financial security for our policyholders.

We would, indeed, attempt to lower prices if we could resolve some of the inefficiencies in the rating and form process.

Senator MENENDEZ. Is that quantifiable?

Mr. WHITE. Show me the law, please, and then I will respond. I am not being facetious, but we would have to know what was available to us.

Mr. MINKLER. Senator, I can say with a high degree of confidence, that in some of our product lines which tend to be more commodity-like products, term insurance and fixed annuities in particular, I think you would see a pass-through of lower regulatory expense directly to the benefit of the consumer.

I cannot tell you precisely how much benefit that would be, but our trade association had a study conducted with the assistance of

CSC Corporation that revealed there are probably billions of dollars of redundant expenses in the current State system. At least there is an opportunity for that to be passed on to the benefit of consumers.

Senator MENENDEZ. Whenever I have different entities come see me and they talk about the consumer incessantly. And then when I ask them well, are you going to pass on whether it is a subsidy that seeks to be eliminated in an agricultural bill or, in this case, the inefficiencies that would seek to be eliminated and therefore produce a revenue stream, whether that revenue stream is used to drive down the cost of insurance or to improve the coverage of insurance or to improve the bottom line for companies that ensure, there is a big huge difference as to who benefits as it relates to consumers.

So I always ask the question how is that going to ultimately affect consumers? Because we can eliminate all the inefficiencies in the world, if it does not get translated to the consumer then it is good for the companies. And I understand the nature of being profitable, but it does not necessarily mean it is good for the consumers.

Mr. Chairman, I have one last question, if I may?

Senator SHELBY. Go ahead.

Senator MENENDEZ. Later on, in the next panel, the Consumer Federation of America lists six different points or problems already under existing issues. I just want to ask about one, their top one.

They say "Insurers are increasingly privatizing profit, socializing risk, creating defective insurance products by hollowing out insurance coverage, and cherry-picking locations in which they will underwrite."

Would that not be exacerbated in a Federal charter?

Mr. BENEDUCCI. First of all, I cannot speak to all of the references that are used there and all of the characteristics that are used. I can respond in terms of how we create product.

The examples that I gave are not unique. We actually ask our customers what is important to them and then try to construct product around meeting those needs.

I think, unfortunately, some of those comments seem more rhetoric than they do factual. I tried to provide some examples that actually are fact, based on what our customers have asked for.

Senator MENENDEZ. Anyone else want to respond to that?

We will wait for the next panel then.

Thank you, Mr. Chairman.

Senator SHELBY. Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman.

Thanks for holding this hearing.

I have a specific question in a different area but I have been unable to get answers that I would like to ask Mr. Beneducci, because Fireman's obviously is a subsidiary of Allianz. And we are having real concerns about Allianz living up to its responsibilities based on the World Trade Center attacks.

Two basic issues. One is that Allianz global risk insurance coverage obligated Allianz to pay $432 million as a result of the 9/11 attacks. Allianz, as I understand it—now there is a court case, say is this one instance or two instances? You lost that in the lower

court, but you are appealing it. So that would bring it up to $865 million, $432 million each. But I am leaving that aside.

You clearly owe $432 million, based on the first court case. You are the only company that has not lived up to that $432 million. You have only paid $312 million. That is number one.

More importantly, a number of insurance companies, when they renegotiated the agreement between Silverstein Properties, the Port Authority, and everybody else said we are going to stick by the agreement because these are just technical changes.

I wrote every insurance company that had not said they would stick by the agreement, including Allianz. Got no answer so far. The letter was about a month old? About a month old, 3 or 4 weeks old.

And so I would ask you two questions. One, why have you not paid the $120 million extra you owe, at least based on the minimal situation which it is a one occurrence and not a two occurrence obligation?

And second, will you stick by your agreement, given this new Port Authority agreement? Or will you try to wriggle out of it?

Again, I have spoken with the heads of other major insurance companies, AIG, Swiss Re, and others. They say they are sticking with it.

Mr. BENEDUCCI. Senator Schumer, unfortunately my answer is probably going to disappoint you, and disappoint you in that by virtue of referencing, by saying what will you do. We are a subsidiary of the parent company. I actually am not involved in the discussions with the parent as it relates to how they are managing that negotiation or that court case.

So I really do not have knowledge of what that position is and the direction that we intend to take. So unfortunately, I cannot answer that question.

Senator SCHUMER. Now, I had asked the Chairman if at some point, when we have a hearing on the insurance industry, if we could take this up.

Senator SHELBY. Sure.

Senator SCHUMER. Since we talked about it a couple of weeks ago, we have gotten no answers.

Senator SHELBY. Maybe we will get the parent here.

Senator SCHUMER. That would be nice.

I hope you will convey to mom and dad——

[Laughter.]

Mr. BENEDUCCI. Point taken.

Senator SCHUMER. ——my concern that we would like answers to these questions.

Mr. BENEDUCCI. Will do.

Senator SCHUMER. Thank you, Mr. Chairman.

Senator SHELBY. I want to thank the panelists. It has been a very long discussion here today, but I think it has been informative, as we examine the changes in the insurance industry and the positions of Senators Sununu and Johnson and others of an optional Federal charter.

We will have more hearings but we thank panel one today. Thank you very much.

We are going to bring up panel two now.

On panel two, we will have Mr. Alan Liebowitz, president of Old Mutual (Bermuda) Limited.

Mr. Robert A. Wadsworth, president and CEO of Preferred Mutual Insurance Company.

Mr. Travis Plunkett, legislative director, Consumer Federation of America.

Mr. Robert M. Hardy, Jr., vice president and general counsel, Investors Heritage Life Insurance Company.

And Mr. Scott Sinder of the Scott Group.

If you will take your seats.

I will say at the outset, all of your written testimony will be made part of the hearing record today, and we are going to have a vote on the Senate floor in about 15 minutes, so if you could basically sum up your testimony. You had the benefit of panel one already.

Mr. Liebowitz, we will start with you.

STATEMENT OF ALAN F. LIEBOWITZ, PRESIDENT, OLD MUTUAL (BERMUDA) LTD.

Mr. LIEBOWITZ. Thank you, Mr. Chairman.

Senator SHELBY. Thank you.

Mr. LIEBOWITZ. Ranking member Sarbanes and members of the Committee. My name is Alan Liebowitz, I am the president of Old Mutual (Bermuda), a company affiliated with the Old Mutual Financial Network. I am here on behalf of the American Banker's Insurance Association, which happens to be the insurance affiliate of the American Banker's Association. And both the ABA and the ABIA participate in the optional Federal Charter Coalition.

If I could leave you with just one message today, it is this, we are currently trying to regulate a national and global business through essentially local government.

The Supreme Court got it right 60 years ago when it determined that insurance is a national business, and we have been in denial ever since. This has resulted in increased inefficiency and complexity. If we are serious about serving the American consumer, serious about safeguarding the ultimate consumer protection, namely a strong, well-capitalized industry, then we need to make significant changes to the way insurance is regulated in this country.

You have heard, and I am sure you will hear again, others will highlight exactly the same problems with the State insurance system as we all have identified previously, and I will avoid doing it again. I would rather focus on the future, and the future is an optional Federal regulatory system.

Senator SHELBY. Thank you.

Mr. LIEBOWITZ. The State system stifles innovation. Seven years after Gramm-Leach-Bliley was passed, there is still no uniformity in producer licensing. If they cannot get that simple function right, how can we expect the States to be able to effectively deal with the increasing complexities of a global insurance market. The solution is an insurance regulatory system, like the one proposed in S. 2509.

Instead of prior review of insurance forms, there would be regulations covering product, form filing after the fact, examinations for compliance, and strong penalties for noncompliance.

A related problem to product availability is the cost of an insurance policy. We allow the markets to set the price for housing, food, clothing, items far more necessary to survival than insurance. Why do we have the Government continue to set prices for insurance?

Last, Mr. Chairman, I would like to address the issue of capacity in our markets by comparing our regulatory system to that of other nations. The difference between foreign insurance regulatory structures and our own are stark.

80 percent of the countries that were surveyed by the International Association of Insurance Supervisors have use and file laws and no requirement for prior rate approval. We are still clinging to both. The proposed national insurance act, proposed by Senator Johnson and Senator Sununu, will advantage consumers by allowing them access to a wider array of products at more competitive prices, increase our global competitiveness, and encourage additional capital investment in our insurance industry.

Let me end with this one thought, if the State insurance departments were in charge of our interstate highway system, we would have cars that would be capable of doing no more than 50 miles an hour, with speed limits of 20 miles an hour. Everyone would need multiple driver's licenses as we went from State to State, and safety measures from State to State, so that foreign manufacturers could not build cars because it would be too complex.

The NAIC would say that we are perfectly safe on the highway and eventually we are going to get to where we need to go. The only question is, at what price?

Thank you.

Senator SHELBY. Mr. Wadsworth.

STATEMENT OF ROBERT A. WADSWORTH, CHAIRMAN AND CEO, PREFERRED MUTUAL INSURANCE COMPANY

Mr. WADSWORTH. Thank you, Chairman Shelby, ranking member Sarbanes, and members of the Committee. My name is Bob Wadsworth and I am pleased to testify today on behalf of the National Association of Mutual Insurance Companies regarding insurance regulatory reform.

Founded in 1895 NAMIC is the Nation's largest property and casualty insurance company trade association with more than 1,400 members underwriting more than 40 percent of the property and casualty premiums in the United States. I am also chairman and chief executive officer of Preferred Mutual Insurance Company, a multi-State PNC writer, located in New Berlin, New York.

Preferred Mutual writes more than $197 million in four States in the Northeast, New York, New Hampshire, Massachusetts, and New Jersey. I also currently serve as chairman of NAMIC.

NAMIC appreciates the opportunity to testify at this important hearing on the future of insurance regulation. Many of the witnesses you will hear today will say—and you have heard today—will say that the current system of State regulation is cumbersome, inefficient, and often denies consumers the benefits of competition. I could not agree more.

Consumers and insurers need a modernized regulatory system that will allow insurers to bring new products to market at com-

petitive prices. While I share my colleagues view with respect to meaningful regulatory reform and that it is critically to our industry and the public we serve, some of us differ over the means of achieving that objective.

NAMIC believes that reforming the State-based regulatory system is preferable to creating a new alternative system of Federal regulation. Let me explain why. Since its inception, the U.S. property and casualty insurance industry has been regulated at the State level. NAMIC believes that State regulation has generally served consumers and insurers well over the years, but that it has not kept pace with changing times.

For example, long after the large national industries experienced sweeping deregulation, property and casualty insurance companies remain subject to rigid price controls in most States. That, more than anything else, must change. We must end price regulation for all lines of property and casualty insurance.

Other matters that deserve attention include the lack of uniformity among States, underwriting restrictions, blanket coverage mandates, and arbitrary and redundant market conduct examinations. That said, State insurance regulation has many strengths that NAMIC believes are worth building upon. Chief among these are the ability of State insurance departments to adapt to local conditions, to experiment and learn from each other, and to respond to unique needs and concerns of consumers in particular areas.

Unlike banking and life insurance, property casualty insurance is highly sensitive to local risk factors, such as weather conditions, torte law, medical costs, and building codes.

What is more, because of the thorough knowledge of local conditions, State regulators are attuned to the needs and interests of each State's consumers. It is unlikely that a distant Federal regulator would have the ability to be nearly as responsive to the unique concerns of consumers in particular States.

Many States have made progress in recent years toward adopting needed reforms. They have softened company licensing restrictions, for example. And in some States, they have moved away from strict rate regulation. The influential national organizations, such as NCOIL, NCSL, and ALEC have called for the abolition of prior approval regulation.

Federal intervention and insurance regulation could take several forms, ranging from a complete Federal takeover, to an optional Federal charter, such as that embodied in S. 2509, to the narrower approaches pursued by the House Financial Services Committee in the various smart bill drafts in H.R. 5637.

With respect to S. 2509, NAMIC believes that an optional Federal charter could lead to negative outcomes that would far outweigh any potential benefits and that many of the anticipated benefits would not be realized.

Let me briefly outline our greatest concern. First, when we examine historical trends in other sectors of the economy, it is clear to us that Federal regulation has proven no better than State regulation at addressing market failures or protecting consumers' interests.

Moreover, unlike State regulatory failures, Federal regulatory can have disastrous economy-wide consequences. The Savings and Loan debacle is just an example.

NAMIC is also concerned that while proponents of Federal regulation may design a perfect system, they can neither anticipate nor prevent the imposition of disastrous social regulation at the Federal level.

By social regulation, I mean the measures that tend to socialize the insurance costs by spreading risk discriminately across different risk classes. Regulations that restrict insurers underwriting freedom often have this effect.

Significantly, there is nothing in S. 2509 that would prevent a Federal insurance regulator from restricting underwriting freedom.

Since my time is almost over, I will conclude, Mr. Chairman.

NAMIC believes that, while States have not acted as rapidly, as thoroughly, to modernize insurance regulation is necessary. We are encouraged that they have picked up the pace of reform and are headed in the right direction. Given this recent progress and the risk associated with creating an entirely new Federal regulatory structure, NAMIC is convinced that reform at the State level is the best and safest course of action for consumers and insurers alike.

Thank you.

Senator SHELBY. Mr. Plunkett.

STATEMENT OF TRAVIS PLUNKETT, LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

Mr. PLUNKETT. Mr. Chairman, Senator Sarbanes, and Members of the Committee. My name is Travis Plunkett, I am the legislative director of the Consumer Federation of America.

I would like to thank you for holding a very timely legislative hearing. Consumers, especially those with low-and moderate-incomes are presently facing a number of very serious problems in the insurance market regarding insurance availability, affordability, and hollowing out of coverage.

These are problems that the State-based regulatory system has largely ignored or failed to adequately address. However, insurance industry proposals that have been introduced recently in the Senate and the House, such as those to create an optional Federal charter and the Federal tools proposal would likely increase these problems while further eroding incentives for loss prevention.

We urge the Committee to reject these anti-consumer proposals, and to examine options that will improve competition in, and oversight of, the insurance market, while increasing regulatory uniformity and protecting consumers.

My main message to you is that tough oversight of the insurance market is not incompatible with vigorous competition.

In fact, the best State regulatory regimes, such as California, achieve both goals. There are many legitimate concerns that Congress could be raising about the problems facing consumers in the insurance market today.

For example, hundreds of thousands of people along the Nation's coasts are having their homeowners' insurance policies nonrenewed and rates are skyrocketing.

Insurers are enjoying their highest profits ever during this time of high losses because they have become increasingly adept at privatizing profit and socializing risk. They have hollowed out insurance coverage, for example, by adding hurricane deductibles and making it much more expensive for consumers to get reimbursed for true replacement costs, and they are now cherry-picking the locations in which they will underwrite.

Pending proposals in Congress do nothing to increase scrutiny of insurer actions that have caused these affordability and availability problems. They also do not deal with other problems. They do not prevent insurers from using inappropriate and possibly discriminatory information to develop insurance rates, such as credit scores. These bills do not spur increased competition in the insurance industry by providing assistance the millions of consumers who find it extremely difficult to comparison shop. They are not stupid, but it is a very complex product, and they find it very difficult to comparison shop.

These bills also do not eliminate the antitrust exemption, under McCarren-Ferguson, that allows the insurance industry to use cartel-like behavior. They do not address the serious problem of reverse competition in certain lines, like credit, title, and mortgage guarantee insurance.

They do not prod State regulators to do more to stop unfair claim settlement practices, of the kind many homeowners on the Gulf Coast have expressed concern about in the wake of Hurricane Katrina.

Instead, these proposals, such as the Federal charter proposal and the smart system. Sanction anticompetitive practices by insurance companies in some cases. Override important State consumer protection laws. Incite State regulators into a race to the bottom to weaken insurance oversight, a trend that has been underway for the last 5 years.

As an example, let us talk about S. 2509, allowing insurers to choose whether they should be regulated by either a Federal body or by State regulators. This can only undermine needed consumer protections by allowing insurers to play State regulators off each other. If elements of the insurance industry truly want to increase their speed-to-market of their products and increase other advantages that uniform Federal regulation would provide, let them propose a Federal approach like that offered in 2003 by Senator Hollings. It has strong consumer protections and would not allow insurers to run back to the States when oversight is tougher than they would like.

Property casualty insurers are particularly ill-suited to a national approach, as dictated in S. 2509, or I should say, allowed in S. 2509. This is because there are so many differences from State to State, and the type of risks that must be covered, as well as the regulatory and legal mandates that must be met.

This bill also creates a Federal regulator that has little, if any, authority to regulate very important items, such as insurance rates, and a limited ability to regulate the form of insurance policies.

Consumers do not care, Senators, who regulates insurance. We only care that the regulatory system be excellent. We are critical

of the current State-based system, but we are not willing to accept a Federal system that guts consumer protections and establishes uniform but very weak regulatory standards.

We agree that better coordination and more consistent standards for licensing and examinations are desirable and necessary and we agree that consumers pay for inefficiencies but these are not the right approaches.

We urge you to look at a wide variety of options to ask the right questions about problems that exist in the market and to continue your investigations.

Thank you, very much.

Senator SHELBY. Mr. Hardy.

STATEMENT OF ROBERT M. HARDY, JR., VICE PRESIDENT AND GENERAL COUNSEL, INVESTORS HERITAGE LIFE INSURANCE COMPANY

Mr. HARDY. Good morning, Senator Shelby, Ranking Member Sarbanes, and Members of the Committee. My name is Rob Hardy, and I am vice president and general counsel of Investors Heritage Life Insurance Company in Frankford, Kentucky.

I am pleased to be here today on behalf of the National Alliance of Life Companies, a trade group that is primarily composed of regional, small, and mid-sized life and health insurance companies.

The NALC supports State regulation of insurance, and opposes the concept of an optional Federal charter. The design for the Federal charter is contemplated in Senate Bill 2509, is purportedly based on a dual charter banking system. However, there is no national crisis, as there was when the Federal banking system was established, compelling Congress to act in order to bolster consumer confidence. There is no outcry from consumers demanding the Federalization of insurance.

To the contrary, according to an ACLI report monitoring the attitudes of the public in 2004, the life insurance is regarded as either very or somewhat favorable to the majority of the people they polled.

Further, a solid majority of consumers agree that life insurers provide good service and employ highly trained professionals. This is hardly a clarion call from consumers for drastic change, like the creation of an entirely new regulatory structure under the Federal Government.

The primary purpose of insurance regulation, which you have heard many times today, is to protect consumers. Attempting to mirror the system that regulates the banking industry is a lot like trying to put the square peg in the round hole.

First, unlike most bank products, which are based on the national commodity, insurance is sold based on individual needs.

Second, the distribution channels are completely different, with insurance companies, which rely primarily on an agency force, while banks rely on customers coming into their branches to transact their business. Insurance has to be sold to individuals by individuals.

As policy conflicts inevitably arise between the Federal insurance regulator and the States, the Federal regulator will ultimately force the States to resolve the conflict. We are concerned that this

is just a first step in a long series of laws that will erode State insurance regulation. Therefore, State charter producers and insurers will not have an option, it will become mandatory.

We certainly applaud Congress for the vital role it has played in encouraging States to take positive reform steps over the last few years. The system is in need of continued improvement, and the march toward modernizing the State regulatory system continues.

However, we are very concerned that the creation of a new Federal bureaucracy to regulate insurance will halt this forward progress and create an entirely new set of problems for everyone concerned.

It is undeniable that some insurance industry groups have been involved in framing the concepts of the optional Federal charter. We think the industry will be exposed to the very real criticism that it is not industry's intent to create a more aggressive regulator, but a friendlier regulator. Creating an industry friendly regulator seems somewhat at odds with the ultimate purpose of insurance regulation, the protection of the consumer.

Indeed, we need smarter, more efficient regulation, but the primary focus must remain on the protection of the policyholders, not the convenience of industry. This may seem odd coming from someone who assists in the management of insurance companies, but we would not be in business if we did not have the trust of our customers.

In creating the National Office of Insurance, the Commission will basically have unlimited powers to employ as many people and create as many offices as deemed necessary. The NALC has indicated that State departments of insurance have handled almost four million consumer inquiries, including complaints, in 2004.

It is hard to imagine the Federal bureaucracy necessary just to handle even a fraction of those inquiries, much less all the other duties that would be required. And this would be in addition to the 10,000 plus State insurance regulators currently employed.

With regard to funding the office, fees and penalties would be charged to the federally chartered companies and producers, while States will still be allowed to receive premium taxes, they will no longer receive revenues from other fees and assessments, producer licensing fees, policy filing fees, examination fees, *et cetera*. This will have a negative impact on State budgets, which is a concern to us.

In conclusion, Congressional initiatives have gone a long way in prompting the NAIC and the various States to adopt necessary model laws that have improved and will improve the State-based system, and will continue to do so.

There are ways to improve efficiency, but regulation of the industry should remain with the States, while Federal legislative tools push States to improve would be a welcome addition, the creation of a large new Federal bureaucracy would not.

Mr. Chairman, thank you for allowing me to share the views of the NALC today.

Senator SHELBY. Mr. Sinder.

STATEMENT OF SCOTT A. SINDER, MEMBER, THE SCOTT GROUP

Mr. SINDER. Thank you, Chairman Shelby. My name is Scott Sinder, I am the member of the law firm, the Scott Group, and I also serve as the general counsel of the Council of Insurance Agents and Brokers. The council represents the Nation's insurance agencies and brokerage firms. Collectively, they sell over 80 percent of all commercial property and casualty insurance placed in this country, last year well over $200 billion.

Senator Sununu, Senator Johnson, we could not thank you enough for introducing the National Insurance Act. It is long overdue. I am going to start by respectfully disagreeing with Mr. Hardy.

I think we do face a national crisis, and I think that you have heard rumblings of it throughout the hearing. And that is, we agree with everything that has been said about the inefficiencies and the inadequacies of the current State system and the need to address them. But one of the reasons we feel that the optional Federal charter is the ultimate solution is because the thing that has not been talked about enough are the national problems that the State system is not situated to address.

We have the flood insurance problem, the uncovered losses in Alabama and the Gulf Coast. We have the terrorism insurance problem.

The Federal solutions that have been proposed to date are band aids. They try to take a little piece of a big business and fix them. But the truth is, it is a national business, an international business. We need a national solution to take the entire business into account and address those solutions.

We do feel that ultimately a Federal charter will be necessary to do that. I would like to say that there is something that we can do in the short-term, though, that would help to facilitate a more efficient marketplace, and it is something that you can do now.

In the House, they have introduced a bill that would clean up an area of surplus lines regulation and make it much more easy to access for commercial policyholders. Surplus lines is exactly what it says. It is nonmandatory insurance that is sold to commercial policyholders, primarily, for them to insure their risks. It is not regulated at the State level. It is a nonregulated product. The people who regulate it in their placement of their product are the brokers.

And the problem is that, today, if you are placing a 55-State risk through the surplus lines marketplace, you have to comply with 55 sets of State regulations. They are all the same.

They impose a premium tax. They have rules on when you can access the surplus lines market. They have rules on which carriers you can place the coverage with. There are licensing requirements for the placing brokers. And there are other filing and disclosure requirements. Every State has the same set, but they are all different and you have to comply with each and every one of them.

So, for example, you have to disclose to your customers that this insurance is not protected by the State guarantee funds. If you place a 50-State policy, you have to include 50 of those disclosures on the policy, one for each and every State in which the policy is placed.

This makes the marketplace very difficult to access for the commercial policyholders, because it is expensive and cumbersome.

But this is the area that is the first market of resort when there is a failure in the marketplace for things like flood insurance and terrorism insurance. And the easiest way to fix this is to dictate that only one set of State's rules applies, the State in which policyholder maintains their corporate headquarters.

That, after all, is the only State that has any real interest in that consumer, because that is where the corporate treasurer resides, and these are risks that the corporation does not have to insure at all.

The other market thing about this particular bill is that all interested stakeholders agree that this is the right solution. The brokers, the carriers, the policyholders that are represented by the risk insurance management society, and even the regulators.

At a June 2005 hearing, Diane Koken, who was, at that time, served as the president of the NALC Council, testified as follows, Federal legislation may be needed at some point to resolve conflicting State laws regarding multi-State transactions. The area where this most likely will be necessary is surplus lines taxation. Federal legislation might also be one option to consider to enable multi-State property risks to access surplus lines coverage in their home State under a single policy and a single set of rules. That is exactly what the House Bill does.

The Business Insurance is the trade publication for the industry. They have also endorsed the proposal. We urge the Committee to consider it.

And in closing I will say, ultimately, though, we also endorse the optional Federal charter proposal of Senator Sununu and Johnson.

Senator SHELBY. Thank you, Mr. Sinder.

In the interest of time, we have got about three or 4 minutes left in the Senate vote on the floor. I am going to submit my questions. I have a number of questions to all of you for the record.

Senator Sununu, Johnson, and Menendez, how about a minute or so apiece?

Senator SUNUNU. I will try to do it in a minute.

First, let me say that on this issue of a crisis, even though he does not support the bill, I am inclined to agree a bit more with Mr. Hardy. There is not a crisis. There is not a huge consumer outcry, and that is exactly why we should be considering this bill now, because when we try to legislate in moments of crisis, or on the basis of populist consumer outcry, we tend to get it wrong.

So, this is the exact time that we should be talking about this and discussing this, so that we can make every effort to get it right. And we may not agree precisely on what constitutes good legislation or bad legislation, but this is a much better environment to address these issues.

I am curious to know of the five panelists, how many of you have checking accounts.

All of you. And how many of you got your checking account through mail order?

Oh. Very interesting.

How many actually went into the bank and talked to a customer service representative to get your account.

I thought that might be the case.

So, let me stipulate that the idea that banks do not use people to sell products to other people is a misnomer. Whether it is a checking account or a savings account or a CD or a mutual fund, there are people at banks that sell products to other people, and we hope that those are good interactions. And the insurance industry certainly is not unique in that regard.

Mr. Wadsworth, why do you not underwrite products in Vermont? You have got Massachusetts, you have got New Hampshire, you have got New York.

Mr. WADSWORTH. Well we, to be perfectly honest, our market share in those four States and the additional market penetration we feel we can engender through time is just such that we feel comfortable in the States we operate.

But, having said that, we certainly, in the future would consider all alternatives.

Senator SUNUNU. It just seems to me odd that you are covering New Hampshire and New York and Massachusetts, but not Vermont. Granted, the population of Vermont is a little bit less than New Hampshire, but I think in many regards, economically, they ought to be similar markets. And you cannot help but draw the conclusion that there are natural barriers to entry here that make it unattractive.

Certainly, I think if you thought that you could make money in Vermont, that if the barriers were not disproportionate, it would seem to make sense that you would do business there.

Thank you, Mr. Chairman. I apologize.

Senator SHELBY. Senator Johnson.

Senator JOHNSON. Well, I think Senator Sununu makes a good point in this case, small States. That the entry into those markets may not justify the expense and the administrative problems and, as a result, consumers have fewer choices and less competition.

I am confounded by the position of CFA here, which is, in effect, an advocacy for business as usual. To endorse a situation which currently leads to a race to the bottom, it would seem that the greater competition and dual regulation would help to stem that.

And it also seems to me that to suggest that a new Federal regulator that is not even established would gut consumer protections is simply a foolish allegation.

Let me ask Mr. Liebowitz and Mr. Sinder. Could you tell me anything about the average time it takes to bring a new insurance product to market, and are consumers harmed by the current regulatory system? How do they benefit from an optional Federal charter? And then, last, I just would note that some of the most heavily regulated States have some of the highest insurance rates for consumers.

But, Mr. Liebowitz and Mr. Sinder, do you care to take a quick shot at that?

Mr. LIEBOWITZ. Well, product filing in and of itself, depending on the States that you are going into, could be as quickly as 30 to 60 days, but it could take as long as a year-and-a-half or two. But that is assuming that the product that you are filing is along a traditional concept.

Where we think that there is the biggest harm being done under the insurance regulatory environment is we are put into a very small box, and the box never gets to move its boundaries.

It is the creativity that we hope would be improved by having a Federal charter with a national regulator who may look at and have other experiences beyond the fairly parochial notion of what is an acceptable insurance risk.

And I heard somebody testify before about some privacy insurance. It did not fit within the paradigm that our insurance regulators were used to. And therefore, it does not matter how long it took, it would never get approved. It would be pocket vetoed.

Senator JOHNSON. Mr. Sinder.

Mr. SINDER. I would concur. There are two basic problems for consumers. They are paying much more for the product because of all the inefficiency and they are not getting access to the types of products that they need to cover the risks that they have in today's world.

Senator JOHNSON. Thank you.

Senator SHELBY. Thank you.

I want to thank the panel again for your information. We do have a number of Senators that are going to submit questions for the record as we build a record in this area. The Committee is adjourned.

[Whereupon, at 12:31 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF ALESSANDRO IUPPA

MAINE SUPERINTENDANT OF INSURANCE, AND

PRESIDENT, NATIONAL ASSOCIATION OF INSURANCE CARRIERS

JULY 11, 2006

Chairman Shelby, Senator Sarbanes, and Members of the Committee, thank you for inviting me to testify before the Committee on insurance regulation reform.

My name is Alessandro Iuppa. I am the Superintendent of Insurance in Maine. I currently serve as President of the National Association of Insurance Commissioners (NAIC) and Chairman of the Executive Committee of the International Association of Insurance Supervisors (IAIS). Prior to becoming the Maine Superintendent of Insurance in 1998, I also served as the Commissioner and Deputy Commissioner of Insurance with the State of Nevada from 1986 to 1991. I am pleased to be here today on behalf of the NAIC and its members to share with the Senate Banking Committee the status of the State system of insurance supervision.

Today, I will make three basic points:

- First, State insurance officials strongly believe that a coordinated, national system of State-based insurance supervision has met and will continue to meet the needs of the modern financial marketplace while effectively protecting individual and commercial policyholders. State insurance supervision is dynamic, and State officials work continuously to retool and upgrade supervision to keep pace with the evolving business of insurance that we oversee. The perfect example of our success is the Interstate Compact for life insurance and other asset-preservation insurance products. Twenty-seven States have joined the Compact in 27 months—with more on the way—and we plan for this State-based national system with its single point of entry and national review standards to become fully operational in early 2007. Across the regulatory spectrum, the members of the NAIC have modernized the State system to implement multi-State platforms and uniform applications. We have leveraged technology and enhanced operational efficiency while preserving the benefits of local protection, which is the real strength of the State system.
- Second, insurance is a unique and complex product that is fundamentally different from other financial services, such as banking and securities. Consequently, the State based system has evolved over the years to address these fundamental differences. Unlike banking products, which provide individuals up-front credit to obtain a mortgage or make purchases, or securities, which offer investors a share of a tangible asset, insurance products require policyholders to pay premiums in exchange for a legal promise rooted in the contractual and tort laws of each State. It is a financial guarantee to pay benefits, often years into the future, in the event of unexpected or unavoidable loss that can cripple the lives of individuals, families and businesses. In doing so, insurance products inevitably touch a host of important and often difficult issues that generally are governed at the State level. State officials are best positioned to respond quickly and to fashion remedies that are responsive to local conditions. We are directly accountable to consumers who live in our communities and can more effectively monitor claims-handling, underwriting, pricing and marketing practices.
- Third, despite States' long history of success protecting consumers and modernizing insurance supervision, some propose to radically restructure the current system by installing a new Federal insurance regulator, developing a new Federal bureaucracy from scratch, and allowing insurance companies to "opt out" of comprehensive State oversight and policyholder protection. Risk and insurance touch the lives of every citizen and the fortunes of every business, and the nation's insurance officials welcome congressional interest in these issues. However, a bifurcated regulatory regime with redundant and overlapping responsibilities will result in policyholder confusion, market uncertainty, and other unintended consequences that will harm individuals, families and businesses that rely on insurance for financial protection against the risks of everyday life. For these reasons, the Senate Banking Committee and Congress should reject the notion of a Federal insurance regime.

State Insurance Protections: Successful and Effective for More Than 135 Years

Risk affects everyone in society in one way or another. Insurance is vested in the public interest by providing economic security to individuals and families against life's many unknowns and by enabling businesses large and small to manage risk

inherent in economic enterprise. The economic well being of every citizen is affected by the strength and efficacy of insurance protections. Therefore, as the public officials responsible for supervising the insurance industry, State insurance officials take great pride in our nation's State-based system of insurance protections that has successfully safeguarded consumers for more than 135 years and overseen the solvency of insurance companies operating in the United States.

The paramount objective of insurance supervision is consumer protection, which is the hallmark of the State system. Each State has an insurance official who is appointed or elected to oversee the financial strength, policy content, market conduct, claims settlement practices, and distribution and marketing systems of insurance companies doing business in his or her State. In each of these areas, an institutional framework and expertise has been developed at the State level to afford policyholders and insurance consumers comprehensive, life cycle protection.

Strong consumer protections instill public confidence in insurance products and thereby serve the interests of the insurance marketplace. Likewise, insurance consumers are served by operational efficiencies that permit insurers to provide a wide array of appropriate products to consumers more quickly and economically. The coordinated, national system of State-based insurance supervision serves the needs of consumers, industry and the marketplace at-large by ensuring hands-on, front-line protection for insurance consumers while providing insurers the uniform platforms and coordinated systems that they need to compete effectively in an ever-changing marketplace.

Insurance: A Unique Financial Product That Is Regulated Effectively by the States

Paying for insurance products is one of the largest consumer expenditures of any kind for most Americans. Figures compiled by the NAIC show that an average family easily can spend a combined total of $7,107 each year for auto, home, life, and health insurance coverage. This substantial expenditure—often required by State law or business practice—is typically much higher for families with several members, more than one car, or additional property to insure. Consumers clearly have an enormous financial and personal stake in making sure insurers keep the promises that they make.

Protecting consumers must start with a basic understanding that insurance is a different business than banking and securities. Banks give consumers the immediate benefit of up-front loans and credit based upon a straightforward analysis of a customer's collateral and ability to pay, and securities can be bought by anyone having the money at a price set by open markets. In contrast, insurance is a commercial product that consumers buy in advance in return for a financial guarantee of future benefits for contingent events specified in the policy. Insurers take into account each customer's potential loss claims, depending on individual risk characteristics, which vary according to the type of insurance, but may include factors such as history of similar losses, sex, age, marital status, medical history, condition of insured property, place of residence, type of business, financial history, "risk management" preparations, or lifestyle choices.

Insurance is thus based upon a series of subjective business decisions—many of which are local rather than national in scope: Where does the risk reside? Is the risk subject to earthquakes or hurricanes? What is the policyholder's risk of civil liability under the laws of the State? Will an insurance policy be offered to a consumer? At what price? What are the policy terms and conditions? What is the structure of the local hospital and physician marketplace? All of these subjective business decisions add up to one absolute certainty: insurance products can generate a high level of consumer backlash and customer dissatisfaction that requires a high level of regulatory expertise, accountability, and responsiveness.

Every day, State insurance departments ensure that insurers meet the reasonable expectations of American consumers—including those who are elderly or low-income—with respect to financial safety and fair treatment. Nationwide in 2004, State insurance departments handled approximately 3.7 million consumer inquiries and complaints regarding the content of policies and the treatment on consumers by insurance companies and agents. Many of these calls were resolved successfully with little or no cost to the consumer. The States also maintain a system of financial guaranty associations that cover policyholder losses in the event of an insurer insolvency. The entire State insurance system is authorized, funded, and operated at absolutely no cost to the Federal Government.

States Oversee a Vibrant, Competitive Insurance Marketplace

In addition to successfully protecting consumers, State insurance officials have proven adept stewards of a vibrant, competitive insurance marketplace. The insur-

ance industry in the United States has grown exponentially in recent decades in terms of the amount and the variety of insurance products and the number of insurers. NAIC data from 2004 shows that there were 6,541 domestic insurers operating in the United States with combined premium of $1.384 trillion. As a share of the U.S. economy, total insurance income grew from 7.4 percent of gross domestic product in 1960 to 11.9 percent in 2000.

Although these national numbers reflect a large industry, most insurers and most of the nation's 3.2 million insurance agents and brokers operate in three or fewer States. Even the giants of the industry use slogans that imply a close knit local flavor such as "like a good neighbor" or "you're in good hands."

Today, companies of various sizes sell a vast array of products across State and national boundaries. A wide range of insurance services has become available to buyers, reflecting the growing national economy and diversity of buyer needs and demand for insurance protection and investment products. Industry changes have compelled the evolution of regulatory institutions, and State supervisory evolution, in turn, has contributed to the development of the insurance industry. This development continues as the industry consolidates, insurers restructure their product lines and companies extend their global operations.

Insurance Regulatory Modernization: A Dynamic Process

Insurance supervision in recent years has been subject to increasing external and internal forces to which the States have responded. Fundamental changes in the structure and performance of the insurance industry have complicated the challenge. Competitive forces have caused insurers to assume increased risk in order to offer more attractively priced products to consumers. Insurance markets have become increasingly national and international in scope and have widened the boundaries of their operations. High costs in some lines of insurance and the economic consequences of natural and man-made disasters have focused greater public attention on supervisory decisions.

Yet the daily transactions that result in most of the premiums for the U.S. insurance industry remain local in nature. The insurance industry today is driven by individuals and families dealing with a local insurance agent to provide coverage for homes and autos, health care from local providers, whole and term life insurance products to protect young families against the economic devastation caused by premature death of a breadwinner, and annuities and other investments to help fund a college education or retirement.

The convergence of forces has had a dramatic effect on the supervision of insurance. Over the past two decades, the States have engaged in an unprecedented program to revamp the framework of insurance oversight. Insurance officials have worked continuously to upgrade the State system to provide multi-State platforms and uniform applications to leverage technology and enhance operational efficiencies. A good share of this effort in the late 1980s and 1990s was directed at strengthening financial oversight by establishing higher capital standards for insurers, expanding financial reporting, improving monitoring tools and accrediting insurance departments. Subsequent initiatives have focused on improving the effectiveness and efficiency of product regulation, market surveillance, producer licensing, company licensing and general consumer protections.

The States have enhanced resources devoted to insurance supervision in terms of coordination, technology and systems to support these efforts, and the NAIC through its members has played a central role in State efforts to strengthen and streamline our oversight of the insurance industry. However, it is important to understand that these are not one-time silver bullet solutions but a dynamic, on-going process that changes and evolves with the business of insurance that we oversee. The modern system of insurance supervision builds on our 135-year record as stewards of a healthy, vibrant insurance marketplace founded upon a bedrock of comprehensive policyholder and consumer protection. But it also demands that State insurance officials be ever vigilant and nimble to anticipate and respond to the ever-changing needs of consumers, the industry and the modern marketplace.

A National System of State-Based Insurance Supervision

The Nation's insurance officials strongly believe that a coordinated, national system of State-based insurance supervision has met and will continue to meet the needs of the modern financial marketplace while enhancing individual and commercial policyholder protections. State insurance supervision is inherently strong when it comes to protecting consumers because we understand local needs and market conditions. State insurance officials also recognize that today's modern financial services marketplace increasingly requires national, harmonized solutions. However, national solutions need not be Federal in nature. To this end, NAIC members have

established a comprehensive program to harmonize, streamline and coordinate State insurance supervision across the regulatory spectrum when a multi-State approach is warranted.

When the NAIC last testified before the Senate Committee on Banking, Housing, and Urban Affairs in September 2004, we shared with you our Reinforced Commitment: Insurance Regulatory Action Plan, in which State insurance officials set clear goals and timetables for States to accomplish the changes needed to achieve a more efficient system of State supervision. In some areas, our goal has been to achieve regulatory uniformity nationwide because it makes sense for consumers and insurers. In areas where different standards among States are justified because they reflect regional market conditions, we are harmonizing and coordinating State regulatory procedures to facilitate compliance.

Three years into this landmark undertaking, the NAIC and its members are proud to report that we remain on time and on target to achieve the goals set forth in the Insurance Regulatory Action Plan. In fact, we are outpacing expectations in some critical areas of reform and on track to reach all key insurance regulatory goals at the scheduled dates. A copy of the NAIC's Insurance Regulatory Action Plan, together with a comprehensive progress update through July 2006, is attached as Attachment A to this statement.

Here is an update on where we stand on a few key initiatives:

Interstate Insurance Product Regulation Compact (IIPRC)

Following enactment of the Compact by 27 States in 27 months, the IIPRC Commission held its inaugural meeting on June 13, 2006, and took the first critical steps to becoming fully operational in early 2007. The Compact creates a single-point-of-filing where insurers can file new life insurance, annuities and other wealth-protection insurance products and receive a single, streamlined review. This vital reform allows insurers to speed new products to market nationally according to strong uniform product standards while preserving a State's ability to address front-line problems related to claims settlement, consumer complaints, and unfair and deceptive trade practices. Although the speed with which States have enacted the Compact has exceeded all expectations and continues to outpace the target set by the Insurance Regulatory Action Plan, State insurance officials have no intention of resting and remain committed to adding new members during the balance of 2006 and beyond.

System for Electronic Rate and Form Filing (SERFF)

SERFF represents the ultimate answer for insurers' speed-to-market concerns. It provides a single-point-of-filing for those products that are not subject to the IIPRC. Insurers that chose to use SERFF to file their products experience an average 23-day turn-around time for the entire filing submission and review cycle. SERFF enables States to include several operational efficiency tools to facilitate an efficient electronic filing. All 50 States, the District of Columbia, Puerto Rico and over 1,800 insurance companies are committed to SERFF. Reflecting on the past 5 years, SERFF has had a tremendous growth in the number of product filings made by insurers electronically, and 2006 is already on target for another impressive year, due to the strong SERFF commitment from the States and industry.

National Licensing System for Insurance Producers

Through the development and use of electronic applications and data bases, State insurance officials have implemented greater efficiencies in the licensing and appointment of insurance producers. Moreover, State insurance officials remain deeply committed to developing further enhancements and achieving greater uniformity in the producer licensing process. State insurance officials have developed an implemented a standard uniform producer licensing application that is used in every State. Additionally, an overwhelming majority of States now accept nonresident licensing applications electronically, and all but a handful of States that require appointments and terminations accept them electronically.

Market Regulation

The NAIC is implementing a more effective and efficient market regulatory system based upon structured and uniform market analysis, uniform examination procedures, and interstate collaboration. A key area of market analysis is the development of a uniform analysis process, which States now are able to use to review complaint activity, regulatory actions, changes in premium volume and other key market indicators. In 2005, over 1,750 uniform market analysis reviews were completed by 48 jurisdictions, and this process was automated to enhance its use and provide States a centralized method to document and share their market analysis conclusions and recommendations. In conjunction with these efforts, the NAIC formed a

high-level working group to provide policy direction for collaborative actions, recommend appropriate corrective actions and common solutions to multi-State concerns, and promote the use of a continuum of cost-effective regulatory responses.

A recent survey indicates that States have decreased the frequency, length and cost of market examinations while increasing regulatory effectiveness. Data received from 39 States show that overall exams from 2003 to 2005 decreased 18 percent and those that did occur were less costly. Moreover, companies experienced reductions in onsite, single State exams and onsite exams that exceeded 1 month. Increased market analysis, targeted examinations, and coordinated regulatory interventions have resulted in more effective and efficient use of State resources and fewer duplicative regulatory efforts. The NAIC continues to make the increased effectiveness and efficiency of market regulation a top priority.

Financial Initiatives

Regulating to ensure the insurance industry remains on solid financial footing and individual insurers have the financial wherewithal to pay their claims obligations continues to be a top priority. With the creation of the NAIC Financial Accreditation Program in 1990, the NAIC has been diligent in reviewing and re-reviewing the standards and practices for assessing financial solvency. The past 5 years, in particular, have challenged the industry with bear markets, large credit defaults, the terrorist attacks of 9-11, ballooning asbestos liabilities and the devastating hurricane seasons of 2004 and 2005. Despite these enormous obstacles, insurers today are reporting positive underwriting and operational results not seen for several decades—a testament to the effectiveness of solvency regulation.

Company Licensing: The NAIC set its sites on standardizing how insurers apply for State licenses to write insurance. To date, the NAIC has developed a Uniform Certificate of Authority Application (UCAA) that establishes the base forms for use in company licensing applications. An electronic system has been built to facilitate the expansion application and communication processes, making it easier than ever to expand business territories. We have largely addressed the issue of State-specific requirements often cited by the industry, and have provided transparency for the State-specific requirements that remain. The NAIC will continue to leverage information technologies and rethink our processes to make business expansion efficient, while keeping focus on protecting consumers from rogue insurance management.

Mergers and Acquisitions: The NAIC also has made great strides toward coordinating solvency activities of insurers that are part of a larger multi-State or multinational group. These activities include merger and acquisition transactions, corporate restructurings and on-going financial solvency monitoring. With States working cooperatively through the NAIC, we are reducing duplicative work and performing more effective financial oversight of insurance enterprises.

Principles-Based Reserving: As part of its modernization efforts, the NAIC is currently developing a principles-based framework for life insurance reserve and capital requirements, utilizing principles of risk management, asset adequacy analysis and stochastic modeling. The framework used previously relied upon a rules-based or formulaic approach to establish reserve and capital requirements for life insurance products. This formulaic approach, as part of a comprehensive solvency agenda, has established a very sound and secure life insurance marketplace in the US. Having established a sound market, the NAIC is now developing reserve and capital requirement methodologies to allow life insurers to more precisely allocate capital relative to the risks of their products. These efforts place the NAIC at the forefront of other international efforts to establish principles-based reserve and capital requirements.

Federal Legislation Must Not Undermine State Modernization Efforts

As States have moved forward to modernize insurance supervision, Congress has begun to consider Federal legislation related to insurance regulation. The NAIC and its members welcome congressional interest in insurance supervision. At the same time, we urge careful analysis of any proposal to achieve modernization of insurance supervision through Federal legislation. Even well intended and seemingly benign Federal legislation can have a substantial adverse impact on existing State protections for insurance consumers. Because Federal law may preempt conflicting State laws, hastily drafted or vague Federal laws can easily undermine or negate important State legal protections for American insurance consumers.

One of the great strengths of State insurance regulation is the fact it is rooted in other State laws that apply when insurable events occur. The NAIC urges Congress to avoid undercutting State authority when considering any Federal legislation that would preempt important consumer protections. Federal laws that appear

simple on their face can have devastating consequences by limiting the ability of State insurance departments to protect the public.

Congress Should Reject Federal Chartering Legislation

Of particular concern to State insurance officials is legislation, "The National Insurance Act of 2006" (S. 2509), that would establish a Federal insurance regulatory authority and allow insurance companies to "opt out" of State oversight and policyholder protections. The NAIC and its members believe that any bifurcated regulatory regime with redundant, overlapping responsibilities will result in policyholder confusion, market uncertainty, and a host of other unintended consequences that will harm individuals, families and businesses that rely on insurance for financial protection against the risks of everyday life. Moreover, State insurance officials caution against any proposal that would treat insurance just like banking and securities products. Failure to recognize the fundamental differences between these industries and how they are supervised would place essential policyholder protections at risk, as well as preempt and transfer the authority of accessible and responsible local officials to a distant, Federal bureaucracy with limited congressional oversight.

Although some have suggested that S. 2509 simply builds upon the best practices of insurance supervision that exist at the State level, this simply is not true. In contrast to the well-established, comprehensive framework of policyholder protections at the State level, S. 2509 dramatically weakens the authority of the new Federal regime to maintain functioning markets and safeguard consumers. Instead, it contemplates bare-bones Federal oversight where the vast majority of regulatory functions—including core protections—would be outsourced to industry-run self-regulatory organizations. Where State laws provide guidance to insurance commissioners regarding consumer safeguards and industry oversight, S. 2509 delegates virtually all decisionmaking to a Federal regime, which would be independent of congressional appropriation and instead funded directly by the same insurance companies that opt for a national charter. S. 2509 would preempt protections in all States that prohibit discrimination on the basis of race, religion and national origin; that require property and casualty insurance rates to be adequate to pay claims and prohibit them from being excessive or unfairly discriminatory; and that ensure that policy forms meet basic policyholder protection standards. While striking down these safeguards currently provided by State law, the bill fails to provide any corresponding Federal safeguards. In fact, it expressly forbids any regulatory standards for the rates that insurers charge, the rating elements that they use to discriminate among risks, and for the policy terms that they offer.

Some have said that a Federal regulatory regime merely adds an optional choice to the insurance regulatory system in the United States, and that it would not seriously affect the existing State system. This assertion is incorrect. A Federal charter may be optional for an insurer choosing it, but the negative impact of federally regulated insurers will not be optional for consumers, producers, State-chartered insurers, State governments, and local taxpayers who are affected, even though they have little or no say in the choice of a Federal charter.

Ultimately, a Federal charter and its regulatory system would result in at least two separate insurance systems operating in each State. One would be the current State-based system established and operated under State law and government supervision. This system would continue responding to State voters and taxpayers. A second system would be a new Federal regulator with little or no experience or grounding in the State laws that control the content of insurance policies, claims procedures, contracts, and legal rights of citizens in tort litigation. Nonetheless, this new Federal regulator would preempt State protections and authorities that disagree with the laws that govern policyholders and claimants of State-chartered insurers. At the very least, this situation will lead to consumer, market and regulatory overlap and confusion. At worst, it will lead to varying levels of consumer protection, perhaps a "race to the bottom" regulatory arbitrage to lower consumer protection standards, as insurers choose to be chartered by Federal or State government based on which offers the most lenient terms.

Granting a government charter for insurers means taking full responsibility for the consequences, including the costs of insolvencies and consumer complaints. The States have fully accepted these responsibilities by covering all facets of insurance licensing, solvency monitoring, market conduct, and handling of insolvent insurers. The members of the NAIC do not believe Congress will have the luxury of granting insurer business licenses without also being drawn into the full range of responsibilities and hard-hitting criticism—fair and unfair—that go hand-in-hand with offering and supervising a government charter to underwrite and sell insurance. Furthermore, we doubt States will be willing to accept responsibility for the mistakes or

inaction of a Federal regulator by including Federal insurers under State guaranty associations and other important, proven consumer protections.

Conclusion

The system of State insurance supervision in the United States has worked well for more than 135 years. State regulators understand that protecting America's insurance consumers is our first responsibility. We also understand that commercial insurance markets have changed, and that modernization of State insurance standards and procedures is needed to facilitate more streamlined, harmonized and efficient regulatory compliance for insurers and producers.

The NAIC and its members—representing the citizens, taxpayers, and governments of all 50 States, the District of Columbia and the territories—will continue to share our expertise with Congress on insurance issues having a national impact and welcome congressional interest in our modernization efforts. We respectfully request Congress and insurance industry participants to work with us to further and fully implement the specific improvements set forth in State officials' *A Reinforced Commitment: Insurance Regulatory Modernization Action Plan.* As our tremendous progress to date shows, this is the only practical, workable way to achieve necessary changes quickly in a manner that preserves and enhances the State protections that consumers demand.

The Nation's consumers require a financially sound and secure insurance marketplace that offers a variety of products and services. They have that now through an effective and responsive State regulatory system. When our record of success is measured against the uncertainties of changing a State-based system that works well at no cost to the Federal Government, State insurance officials believe that Congress will agree that regulating insurance is best left to home State officials who have the expertise, resources, and experience to protect consumers in the communities where they live.

Thank you for this opportunity to address you, and I look forward to your questions.

Attachment A

A Reinforced Commitment: Insurance Regulatory Modernization Action Plan

(Updated—July 2006)

Consumer Protection

An open process . . . access to information and consumers' views . . . our primary goal is to protect insurance consumers, which we must do proactively and aggressively, and provide improved access to a competitive and responsive insurance market.

The NAIC members will keep consumer protection as their highest priority by:

(1) Providing NAIC access to consumer representatives and having an active organized strategy for obtaining the highly valued input of consumer representatives in the proceedings of all NAIC committees, task forces, and working groups;

Update: To help ensure active and organized consumer representation, the NAIC provides funding for consumer representatives to participate in NAIC activities. The NAIC also formally recognizes three unfunded consumer representatives. Finally, the NAIC's Consumer Protections Working Group provides a formal structure for consumer issues.

(2) Developing disclosure and consumer education materials, including written and visual consumer alerts, to help ensure consumers are adequately informed about the insurance market place, are able to distinguish between authorized an unauthorized insurance products marketed to them, and are knowledgeable about State laws governing those products;

Update:

Insure U

Under the theme, Insure U—Get Smart About Insurance, in March 2006, the NAIC created a virtual "university curriculum" of helpful information that teaches consumers about the four basic types of insurance: auto, home, life and health. And, to be most helpful, our curriculum is organized around four specific life stages: young singles, young families, established families and empty nesters/seniors. Importantly, the campaign also covers the NAIC's "Fight Fake Insurance . . . Stop. Call. Confirm."

The heart of Insure U is our online educational curriculum available at *www.InsureUonline.org.* When consumers arrive at the Insure U site, they are invited to select a life stage pathway that will teach them about insurance issues and

considerations directly related to their needs. Upon completing a life stage Insure U curriculum, consumers are invited to take a short online quiz. If they achieve a passing grade on the quiz, they can print out a diploma, certifying their successful completion of the Insure U curriculum.

As part of this campaign, the NAIC produced a new TV public service announcement that warns consumers to protect themselves from being scammed by fake insurance companies. The PSA employs the metaphor of a house of cards that collapses when a consumer submits an insurance claim, illustrating how an individual's foundation of protection can be shattered by buying a policy from a fake insurance company. The spot concludes with our strong tagline: Stop. Call. Confirm. Consumers may also call a toll-free telephone number to find consumer representatives in their home State insurance departments. In addition to reaching English-speaking consumers, the NAIC has created two radio PSAs specifically for the Hispanic community.

Stop. Call. Confirm. Fight Fake Insurance Campaign

The NAIC has continued efforts to warn insurance consumers about potential fraud through a national consumer awareness and media outreach campaign titled "Fight Fake Insurance: Stop. Call. Confirm." The campaign, in its second year, features as its spokesperson nationally known fraud expert and former con man Frank Abagnale, whose life story was depicted in the movie "Catch Me If You Can." The NAIC developed and distributed a public service announcement featuring Abagnale, which was distributed to television radio stations nationwide. The PSAs included a 7-second tagline at the end mentioning the respective State insurance department and contact information. A generic version of the PSA is on the NAIC website *www.naic.org.* To date, the spot received more than 60,000 broadcast hits, 78 print placements and 93 online media placements for a total of 268 million media impressions.

Get Smart About Insurance Week

The NAIC continued the tradition and success of Get Smart About Insurance Week, a campaign that has involved more States each year, since its inception. In 2005, a record high of 48 States took part and implemented the consumer awareness program locally and on a statewide level. This program received 77 million media placements.

(3) Providing an enhanced Consumer Information Source (CIS) as a vehicle to ensure consumers are provided access to the critical information they need to make informed insurance decisions;

Update: The CIS allows consumers to view a variety of information about insurance companies and to file a consumer complaint or a report of suspected fraud with a State insurance department. In 2005, the NAIC Web site was updated with Frequently Asked Questions and information regarding automobile insurance, life insurance, health insurance, and homeowners insurance. In addition, general educational information was added to aid consumers in identifying a company that might be servicing an existing life insurance policy. To address the special insurance needs of military personnel, the NAIC Web site was updated with insurance information specifically tailored to the needs of military personnel. Finally, the NAIC Web site contains consumer alerts on flood insurance, consumer preparedness for storms, Medicare Part D, annuities sales to seniors and identity theft insurance. Almost 219,000 users accessed the CIS Web site for 1,201,495 hits in 2005.

(4) Reviewing and assessing the adequacy of consumer remedies, including State arbitration laws and regulations, to ensure that appropriate forums are available for adjudication of disputes regarding interpretation of insurance policies or denials of claims; and

Update: The Consumer Protections Working Group reviewed a detailed summary of the testimony received during its two public hearings in 2003. Because of the extensive testimony and focus this issue received in 2003, the working group agreed the issues regarding State arbitration laws have been appropriately reviewed and that further discussion on this issue is unnecessary at this time. The Consumer Protections Working Group and the Consumer Liaison Committee continue to serve as the appropriate forums for discussing and assessing consumer remedies.

(5) Developing and reviewing consumer protection model laws and regulations to address consumer protection concerns.

Update: The Consumer Protections Working Group oversees this effort as necessary. For example, in 2005 the Working Group completed a study addressing the effectiveness of consumer disclosures that accompany insurance products. In 2006, the Working Group is identifying key elements that should be included in consumer disclosures.

Market Regulation

Market analysis to assess the quality of every insurer's conduct in the marketplace, uniformity, and interstate collaboration . . . the goal of the market regulatory enhancements is to create a common set of standards for a uniform market regulatory oversight program that will include all States.

The NAIC has established market analysis, market conduct, and interstate collaboration, as the three pillars on which the States' enhanced market regulatory system will rest. The NAIC recognizes that the marketplace is generally the best regulator of insurance-related activity. However, there are instances where the market place does not properly respond to actions that are contrary to the best interests of its participants. A strong and reasonable market regulation program will discover these situations, thereby allowing regulators to respond and act appropriately to change company behavior.

The NAIC, in conjunction with the National Conference of Insurance Legislators, has helped develop the statutory framework set forth in NCOIL's Market Conduct Surveillance Model Act. The provisions of this model act are consistent with the NAIC's reforms of market analysis, uniform examination procedures and interstate collaboration. The NAIC will consider the adoption of the NCOIL model act as an NAIC model act at or prior to the NAIC 2004 Fall National Meeting.

Market Analysis

While all States conduct market analysis in some form, it is imperative that each State have a formal and rigorous market analysis program that provides consistent and routine reports on general market problems and companies that may be operating outside general industry norms. To meet this goal:

(1) Each State will produce a standardized market regulatory profile for each "nationally significant" domestic company. The creation of these profiles will depend upon the collection of data by each State and each State's full participation in the NAIC's market information systems and new NAIC market analysis standards; and

Update: Based upon the information contained in the market information systems, the NAIC developed and implemented automated programs that generate standardized market regulatory profiles, which include the following 5-year information for each company: (1) State specific premium volume written, (2) modified financial summary profile, (3) complaints index report, (4) regulatory actions report, (5) special activities report, (6) closed complaints report, (7) exam tracking systems summary, (8) modified IRIS ratios, (9) defense costs against reserves information, and (10) Schedule T information.

In 2004, the NAIC created Level 1 Analysis, which consists of 16 uniform questions that are used by market analysts to evaluate individual companies without the need to contact them for additional information. In 2005, the Market Analysis Review System (MARS) application automated the Level 1 Analysis questions, and provided States with access to see analysis performed by other States. In addition, the NAIC developed a further level of analysis (Level 2 Analysis), which provides analysts with detailed recommendations concerning additional places to obtain crucial information on insurers, both inside and outside of the insurance industry. Toward the end of 2006, the NAIC will release a Company Listing Prioritization Tool, which will aid analysts in identifying outliers for various measures.

(2) Each State will adopt uniform market analysis standards and procedures and integrate market analysis with other key market regulatory functions.

Update: The NAIC adopted the Market Analysis Handbook during the NAIC Winter National Meeting in December 2003. The guidelines in this handbook provide States with uniform market analysis, standards, and procedures, which will integrate market analysis with other regulatory functions. In 2005, the NAIC combined the NAIC's Market Analysis Handbook with the NAIC's Market Conduct Examiners Handbook to create a more integrated system of market regulation. The purpose of the new Market Regulation Handbook is to identify data and other information that is available to regulators, and provide guidance on how that data can be used to target the most significant market problems with the most efficient regulatory response

Finally, the market conduct annual statement pilot project became a permanent NAIC project in 2004 and continues to serve as a market analysis tool that eighteen participating States use to consistently review market activity of the entire insurance market place and identify companies whose practices are outside normal ranges. This tool is meeting its objective to help States more effectively target market regulatory efforts. With this success, the NAIC is now discussing the need for centralization of this data. That step will provide States even greater uniformity in comparing companies' performance, not only within their respective States, but also across the various States, thus providing enhanced opportunities for coordinating

market regulatory efforts. As the statement continues to develop, States should be able to reduce the number of State-specific data calls, and move toward collecting data about claims, nonrenewals and cancellations, replacement-related activity and complaints on an industry-wide basis.

Market Conduct

States will also implement uniform market conduct examination procedures that leverage the use of automated examination techniques and uniform data calls; and

(1) States will implement uniform training and certification standards for all market regulatory personnel, especially market analysts and market conduct examiners; and

Update: A Market Analysis track was added to the NAIC's E-Regulation Conference held annually in May. Because the NAIC funds each State to send a market regulator to this conference, significant training on market analysis techniques is accomplished through this conference. In addition, the NAIC offers a classroom market analysis training every August and multiple on-line market analysis training sessions each year. Finally, market analysis techniques were incorporated into the NAIC's Staff Education Program and Integrating Market Regulation Programs.

In 2006, the NAIC is implementing its Insurance Regulator Professional Designation Program to provide professional growth opportunities for State insurance regulators at all levels, and to promote the improvement of their knowledge, skills and best practices in the areas of consumer protection, insurer solvency and market conduct regulation. The designation program will provide insurance regulators with a NAIC-sponsored professional designation recognizing their expertise in insurance regulation, including market regulatory functions. Regulators who complete the NAIC Designation Program will be better equipped to provide high quality services and protections to insurance consumers.

(2) The NAIC's Market Analysis Working Group will provide the expertise and guidance to ensure the viability of uniform market regulatory oversight while preserving local control over matters that directly affect consumers within each State.

Update: The Market Analysis Working Group (MAWG) is already a functioning group using adopted protocols for the coordination and collaboration of market regulatory interventions. In 2005, the structure of MAWG was refined to become a higher level working group, analogous to the Financial Analysis Working Group. MAWG is now carrying out the following functions: (1) providing policy oversight and direction of the Collaborative Action Designees (CADs), collaborative analysis and collaborative regulatory interventions; (2) facilitating interstate communication and coordinating collaborative State regulatory actions, (3) recommending appropriate corrective actions and common solutions to multi-State problems, and (4) facilitating the use of a broader continuum of regulatory responses.

Interstate Collaboration

The implementation of uniform standards and enhanced training and qualifications for market regulatory staff will create a regulatory system in which States have the confidence to rely on each other's regulatory efforts. This reliance will create a market regulatory system of greater domestic deference, thus allowing individual States to concentrate their market regulatory efforts on issues that are unique to their individual market place conditions.

Update: To help minimize variations in market conduct examinations so that States can rely on each other's findings, the NAIC adopted the Market Conduct Uniform Examination Outline. This outline, which was developed in 2002, focuses on the following four areas: (1) exam scheduling, (2) pre-exam planning, (3) core examination procedures and (4) exam reports. Forty-one States and the District of Columbia have self-certified compliance with all four uniform examination areas. To ensure public accountability, the NAIC adopted a process for resolving complaints about State noncompliance with Uniform Examination Procedures.

In 2005, the NAIC adopted uniform core competencies, which each State is encouraged to implement, for the following areas: (1) resources, (2) market analysis, (3) continuum of regulatory responses and (4) interstate collaboration. In 2006, the NAIC Market Regulation and Consumer Affairs Committee will focus on consumer complaint handling procedures and enhancing the continuity of regulatory responses.

(1) Each State will monitor its "nationally significant" domestic companies on an on-going basis, including market analysis and appropriate follow up to address any identified problems; Update: As referenced above, NAIC staff has provided company profiles to each State for initial baseline monitoring of company activity. The Market Analysis Handbook contains a spectrum of regulatory responses that might be initiated. For example, the handbook identifies responses that could range from con-

sumer outreach and education to a desk audit to an onsite examination. The NAIC is also creating a list of regulatory actions that can be taken before an exam is called. Through the release of the Market Initiative Tracking System (MITS) in June of 2006, States now have the ability to track a broader continuum of market regulatory actions by entering these actions into a centralized, electronic data base.

(2) Market conduct examinations of "nationally significant" companies performed by a nondomestic State will be eliminated unless there is a specific reason that requires a targeted market conduct examination; and

Update: States continue to move toward targeted examinations based upon market analysis, and are coordinating their efforts through MAWG. The NAIC Examination Tracking System shows that the number of comprehensive examinations conducted by non-domiciliary States has dropped almost in half in the last 3 years (from 427 in 2003 to 226 in 2005). At the same time, the number of desk examinations and targeted examinations has increased substantially (from 3 desk examinations in 2003 to 30 in 2005 and from 230 targeted examinations in 2003 to 346 in 2005.)

(3) The Market Analysis Working Group will assist States to identify market activities that have a national impact and provide guidance to ensure that appropriate regulatory action is being taken against insurance companies and producers and that general market issues are being adequately addressed. This peer review process will become a fundamental and essential part of the NAIC's market regulatory system.

Update: The NAIC adopted Market Analysis Working Group (MAWG) procedures, which set forth guidelines for interstate collaboration and centralized coordination through MAWG. Through MAWG, States are made aware of analysis that points to potential market issues that could have a national impact. In addition, MAWG ensures that participants receive guidance and updates on on-going collaborative efforts. For example, MAWG oversaw the coordination of two recent settlements involving military personnel. Another key aspect is the development of a referral process for States to use when referring potentially troubled companies to MAWG. This process is being successfully used by States. After referral, MAWG collaboratively decides on a recommended course of action.

"Speed to Market" for Insurance Products

Interstate collaboration and filing operational efficiency reforms . . . State insurance commissioners will continue to improve the timeliness and quality of the reviews given to insurers' filings of insurance products and their corresponding advertising and rating systems.

Insurance regulators have embarked on an ambitious 'Speed to Market Initiative' that covers the following four main areas:

1. Integration of multi-State regulatory procedures with individual State regulatory requirements;
2. Encouraging States to adopt regulatory environments that place greater reliance on competition for commercial lines insurance products;
3. Full availability of a proactively evolving System for Electronic Rate and Form Filing (known as 'SERFF') that includes integration with operational efficiencies (best practices) developed for the achievement of speed to market goals; and
4. Development and implementation of an interstate compact to develop uniform national product standards and provide a central point of filing.

Update: To demonstrate that States are up to the challenge of providing speed to market for insurance products without sacrificing adequate consumer protection, a system of measurement is needed. NAIC has developed a set of uniform metrics that rely on the four operational efficiencies listed above. The Action Plan establishes 2008 as the goal for universal use; however, those working on the project believe most jurisdictions will implement filing metrics long before that date. SERFF has the necessary counting and reporting framework for both paper and electronic product filings, and has been implemented in all States.

Integration of Multi-State Regulatory Procedures

It is the goal that all State insurance departments will be using the following regulatory tools by December 31, 2008:

(1) Review standards checklists for insurance companies to verify the filing requirements of a State before making a rate or policy form filing;

Update: The review standards checklists provide a means for insurance companies to verify the filing requirements of a State before making a rate or policy form filing. The checklists contain information regarding specific State statutes, regula-

tions, bulletins or case law that pertain to insurance issues. Currently, most States have developed and posted Review Standards Checklists to their State Web sites. All insurers may access the information for all States via the NAIC Web site.

States report that insurers taking advantage of this regulatory modernization have found the likelihood for successfully submitting a filing increases dramatically, vastly improving speed to market for insurers.

(2) Product requirements locator tool, which is already in use, will be available to assist insurers to locate the necessary requirements of the various States to use when developing their insurance products or programs for one or multiple-State markets;

Update: The product requirements locator tool is available to assist insurers in locating the necessary requirements of various States, which must be used when developing insurance products for one or more States. This program allows someone to query a searchable NAIC data base by product (*i.e.,* auto insurance), requirement (*i.e.,* cancellation statute), or State to determine what is needed to develop an insurance product or make a filing in one specific State or many States, for one type of insurance or for many types of insurance. Thirty States have populated the property and casualty product requirements locator tool, and eight States are in the process of populating the tool. The life and health product requirements locator tool is being re-tooled for greater efficiency, and should be considered under development. The Action Plan establishes a goal of 2008 for universal use; however, those working on the project believe most jurisdictions will implement this long before that date.

(3) Uniform product coding matrices, already developed, will allow uniform product coding so that insurers across the country can code their policy filings using a set of universal codes without regard for where the filing is made; and

Update: Product coding matrices have been developed to provide a uniform product naming convention and corresponding product coding, so that insurers across the country can seamlessly communicate with insurance regulators regarding product filings. This key feature forms the basis for counting and measuring speed to market for insurance products. The Action Plan establishes a goal of 2008 for universal use. To date, 42 States have implemented the Uniform Product Coding matrix within SERFF and other States are in progress.

(4) Uniform transmittal documents to facilitate the submission of insurance products for regulatory review. The uniform transmittal document contains information that is necessary to track the filing through the review process and other necessary information. The goal is that all States adopt it for use on all filings and data bases related to filings by December 31, 2003.

Update: Uniform transmittal documents were developed to permit uniform product coding, so that insurers across the country can code their policy filings using a set of universal codes without regard for where the filing is made. Instead of using the numerous codes developed historically by each individual State for its own lines of insurance, a set of common codes have been developed, using the annual statement blanks as a guideline, in an effort to eliminate the need for insurance companies to keep separate lists of codes for each State insurance department's lines of insurance. To date, 18 States have fully implemented use of the Uniform Transmittal Documents in SERFF, and others are in varying states of progress. The Action Plan establishes a goal of 2008 for universal use; however, those working on the project believe most jurisdictions will implement this long before that date.

It is important to note that the SERFF system is being modified to model the adopted uniform transmittal documents. When version 5 of SERFF is released later in 2006, the Uniform Transmittal Documents will effectively be in use by all States by virtue of the system design.

Adoption of Regulatory Frameworks That Place Greater Reliance on Competition

States will continue to ensure that the rates charged for products are actuarially sound and are not excessive, inadequate or unfairly discriminatory. To the extent feasible, for most markets, States recognize that competition can be an effective element of regulation. While recognizing that State regulation is best for insurance consumers, it also recognizes that State regulation must evolve as insurance markets change.

Update: The NAIC has adopted a model law that places greater reliance on competition for commercial lines insurance products. It is actively encouraging States to consider it; however, hard market conditions in the property and casualty insurance markets in many States make it difficult for State legislators to support a relaxing of rate regulatory requirements in a time when prices are dramatically rising for businesses seeking coverage. The NAIC's Personal Lines Market Regulatory Framework Working Group has discussed whether an appropriate regulatory frame-

work can be agreed upon by NAIC members. Its work should be completed by the end of the year.

Full availability of a proactively evolving System for Electronic Rate and Form Filing (SERFF)

SERFF is a one-stop, single point of electronic filing system for insurance products. It is the goal of State insurance departments to be able to receive product filings through SERFF for all major lines and product types by December 2003. We will integrate all operational efficiencies and tools with the SERFF application in a manner consistent with our Speed to Market Initiatives and the recommendations of the NAIC's automation committee.

Update: SERFF is the ultimate answer to speed to market concerns of insurers. All 50 States, the District of Columbia, and Puerto Rico are SERFF-ready. Insurers that have chosen to use SERFF are experiencing an average 23-day turn-around time for the entire filing submission and review cycle. SERFF offers functionality that can enable all regulatory jurisdictions to accept electronic rate and form filings from insurance companies for all lines of insurance and product types. There are 51 jurisdictions accepting filings for the property/casualty line of business, 47 of which are accepting all major lines. There are 49 States accepting life filings, 43 of which are accepting all major lines, and 46 States are currently accepting health filings via SERFF, 38 of which are accepting all major lines. SERFF enables States to include all operational efficiency tools such as the review standards checklists, requirements included in the product requirements locator, and uniform transmittal documents to facilitate an efficient electronic filing process. There are over 1,800 insurance companies licensed to use SERFF and nearly 184,000 filings were submitted via SERFF thus in 2005. Thus far in 2006 (as of June 30), nearly 132,000 filings have been submitted, averaging over 1,000 per day. The NAIC estimates that the total universe in an average year is approximately 750,000 total filings.

Implementation of an Interstate Compact

Many products sold by life insurers have evolved to become investment-like products. Consequently, insurers increasingly face direct competition from products offered by depository institutions and securities firms. Because these competitors are able to sell their products nationally, often without any prior regulatory review, they are able to bring new products to market more quickly and without the expense of meeting different State requirements. Since policyholders may hold life insurance policies for many years, the increasing mobility in society means that States have many consumers who have purchased policies in other States. This reality raises questions about the logic of having different regulatory standards among the States.

The Interstate Insurance Product Regulation Compact will establish a mechanism for developing uniform national product standards for life insurance, annuities, disability income insurance, and long-term care insurance products. It will also create a single point to file products for regulatory review and approval. In the event of approval, an insurer would then be able to sell its products in multiple States without separate filings in each State. This will help form the basis for greater regulatory efficiencies while allowing State insurance regulators to continue providing a high degree of consumer protection for the insurance buying public.

State insurance regulators will work with State law and policymakers with the intent of having the Compact operational in at least 30 States or States representing 60 percent of the premium volume for life insurance, annuities, disability income insurance and long-term care insurance products entered into the Compact by year-end 2008.

Update: The NAIC adopted draft model legislation for the Interstate Insurance Product Regulation Compact (the "Compact") in December 2002. Working with the National Conference of State Legislatures (NCSL), the National Conference of Insurance Legislators (NCOIL), the National Association of Attorneys General (NAAG), as well as the American Council of Life Insurers (ACLI) and consumers, the NAIC adopted technical amendments to the model legislation in July 2003. The NCSL and NCOIL endorsed the Compact in July 2003.

Beginning with Colorado in March 2004, the Governors and legislatures of 27 States adopted the Compact legislation in 27 months. These 27 States include: Alaska, Colorado, Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Minnesota, Nebraska, New Hampshire, North Carolina, Oklahoma, Ohio, Pennsylvania, Puerto Rico, Rhode Island, Texas, Utah, Vermont, Virginia, Washington, West Virginia and Wyoming. These 27 States represent approximately 42 percent of the premium volume, and the Compact legislation remains under consideration this year in the District of Columbia, Massachusetts, Michigan, and New Jersey.

The Compact legislation set the high bar of 26 States or States representing 40 percent of the Nation's premium volume to become operational. After surpassing both triggers in the spring 2006, the Compact Commission held its inaugural meeting on June 13, 2006, in Washington, DC, and initiated an action plan to make the Compact fully operational in early 2007. At the meeting, the Commission formed an Interim Management Committee, elected Pennsylvania Insurance Commissioner Diane Koken as the Interim Management Committee Chair, began the process to adopt Commission Bylaws by September 2006, and established an Interim Legislative Committee, consumer and industry advisory committees, and a number of operational committees to coordinate important elements of the startup process. These critical steps will prepare the Compact to be ready to begin receiving and making regulatory decision on product filings during the first part of 2007.

Producer Licensing Requirements

Uniformity of forms and process . . . the NAIC's broad, long-term goal is the implementation of a uniform, electronic licensing system for individuals and business entities that sell, solicit or negotiate insurance.

The States have satisfied GLBA's licensing reciprocity mandates and continue to view licensing reciprocity as an interim step. Our goal is uniformity.

Building upon the regulatory framework established by the NAIC in December of 2002, the NAIC's members will continue the implementation of a uniform, electronic licensing system for individuals and business entities that sell, solicit or negotiate insurance. While preserving necessary consumer protections, the members of the NAIC will achieve this goal by focusing on the following five initiatives:

(1) Development of a single uniform application;

Update: The NAIC adopted a Uniform Producer Licensing Application that can be used for both resident and non-resident licensing. Every State accepts the Uniform Producer Licensing Applications for non-resident licensing. Thirty-four States accept the Uniform Producer Licensing Applications for resident licensing.

(2) Implementation of a process whereby applicants and producers are required to satisfy only their home State pre-licensing education and continuing education (CE) requirements;

Update: This system of CE reciprocity is already established and working. The NAIC continues to monitor this system to ensure CE reciprocity remains in place. In addition, States are streamlining the CE course approval process for CE providers. Forty-eight States and the District of Columbia have signed the Uniform Declaration Regarding CE Course Approval Guidelines.

(3) Consolidation of all limited lines licenses into either the core limited lines or the major lines;

Update: The NAIC has adopted definitions for the following core limited lines, and has included these limited lines as part of the uniform applications: Car Rental, Credit, Crop, Travel and Surety. Thirty States have adopted the NAIC definitions. The remaining States continue to pursue legislative changes to consolidate all their limited lines into these core categories. This process will continue through the 2006 State legislative sessions.

(4) Full implementation of an electronic filing/appointment system; and

Update: Forty States and the District of Columbia have implemented an electronic filing/appointment system. In addition, five States are processing electronic appointment renewals. Nine States do not require appointments. The NAIC and its affiliate, the National Insurance Producer Registry, continue to work with the remaining States to implement an electronic filing/appointment system.

(5) Implementation of an electronic fingerprint system. In accomplishing these goals, the NAIC recognizes the important and timely role that State and Federal legislatures must play in enacting necessary legislation.

Update: The NAIC successfully implemented a fingerprint pilot program with the States of Alaska, California, Idaho and Pennsylvania submitting fingerprints to the NAIC's centralized fingerprint repository during 2005 and 2006. California and Pennsylvania have since suspended their submissions to the repository. In addition, the NAIC adopted an Authorization for Criminal History Record Check Model Act, which provides States with the necessary language to obtain clear authority to collect fingerprints and obtain criminal history record information from the FBI. While States are currently able to obtain access to the FBI data base through the adoption of proper legislative authority, Federal law prohibits States from sharing criminal history record information with each other. The NAIC continues to seek solutions to enhance States access to the FBI data base and resolve the prohibition against the sharing of such information among the States.

National Insurance Producer Registry (NIPR)

Through the efforts of NIPR, major steps have been taken to streamline the process of licensing non-residents and appointing producers, including the implementation of programs that allow electronic appointments and terminations. Other NIPR developments helping to facilitate the producer licensing and appointment process include:

Update: There are 41 States and the District of Columbia accepting electronic non-resident licensing applications through NIPR with the goal of all States and territories by December 31, 2006. There are 17 States on electronic non-resident renewals. In addition, three States are processing electronic resident licensing applications, and five States are processing electronic resident renewals.

(1) Use of a National Producer Number (NPN), which is designed to eliminate sole dependence on using social security numbers as a unique identifier;

Update: There are 42 States and the District of Columbia currently using the NPN as the unique identifier on the data base.

(2) Acceptance of electronic appointments and terminations or registrations from insurers;

Update: There are 40 States and the District of Columbia accepting electronic appointments and terminations through NIPR's Gateway. Nine States do not require appointments. In addition, five States are processing electronic appointment renewals. The NAIC and its affiliate, the National Insurance Producer Registry, continue to work with the remaining States to implement an electronic filing/appointment system.

(3) Use of Electronic Funds Transfer for payment of fees. The goal is to have full State implementation of the services provided by NIPR by December of 2006.

Update: There are 32 States using Electronic Funds Transfer for payment of fees.

Insurance Company Licensing

Standardized filing and baseline review procedures . . . the NAIC will continue to work to make the insurance company licensing process for expanding licensure as uniform as appropriate to support a competitive insurance market.

Except under certain limited circumstances, insurance companies must obtain a license from each State in which they plan to conduct business. In considering licensure, State regulators typically assess the fitness and competency of owners, boards of directors, and executive management, in addition to the business plan, capitalization, lines of business, market conduct, *etc.* The filing requirements for licensure vary from State to State, and companies wishing to be licensed in a number of States have to determine and comply with each State's requirements. In the past 3 years, the NAIC has developed, and all States have agreed to participate in, a Uniform Certificate of Authority Application process that provides significant standardization to the filing requirements that non-domestic States use in considering the licensure of an insurance company.

Update: Presently, all 50 States and the District of Columbia accept the NAIC's Uniform Certificate of Authority Application (UCAA) from insurers desiring to do business in their State. The UCAA has been under development for sometime and work continues to eliminate a few remaining State-specific filing requirements. However, many of these additional requirements result from State statute or regulation in a small number of States.

In its commitment to upgrade and improve the State-based system of insurance regulation in the area of company licensing, the NAIC will:

(1) Maximize the use of technology and pre-population of data needed for the review of application filings;

Update: NAIC Information Systems staff, with assistance from an outside consultant, has completed a comprehensive business analysis of the UCAA system. As a result, numerous modifications to improve the application's automation and user-friendliness were recommended and approved by the National Treatment and Coordination Working Group. Two of the more significant recommendations were: convert the system to a data input driven system versus a form-based system, and modify the applications to interface with the Financial Data Repository (FDR) to extract all possible application elements in order to complete the UCAA more efficiently. These changes were implemented for both the expansion and corporate amendment applications, and are currently in production in the electronic UCAA tool.

(2) Develop a Company Licensing Model Act to establish standardized filing requirements for a license application and to establish uniform licensing standards; and

Update: The National Treatment and Coordination Working Group is in the process of developing this model act. The Working Group reviewed areas of the company licensing process that cause the most problems and additional work for insurer ap-

plicants due to non-uniformity amongst the States. As a result of that review, the Working Group dedicated itself to first addressing uniformity in the definitions of lines of business and in capital and surplus requirements, two very complicated areas with wide-ranging implications to various regulatory processes. The Working Group is currently considering two primary proposals regarding definitions of lines of business: using the lines of business from the statutory financial statement or using broader categories of business that incorporate multiple lines of business from the statutory financial statement within each category. The Working Group is also discussing ways to synchronize these definitions with those used in the product licensing area, to achieve even greater uniformity and synergy.

(3) Develop baseline licensing review procedures that ensure a fair and consistent approach to admitting insurers to the market place and that provide for appropriate reliance on the work performed by the domestic State in licensing and subsequently monitoring an insurer's business activity.

Update: Through the efforts of a consultant and the National Treatment and Coordination Working Group, the Company Licensing Best Practices Handbook was completed and adopted by the NAIC. This publication provides a wealth of best practices for the entire company licensing review process that occurs in each State. The most significant areas addressed in the publication are the use of a prioritization system for allocating review resources to various applications, communication between the domiciliary and expansion States, and review considerations that should be stressed for the various application types. These best practices establish a consistent approach for reviewing company licensing applications, and encourage efficiency in review procedures to help ensure timely company licensing decisions occur.

As company licensing is adjunct to a solvency assessment, the members of the NAIC will consider expanding the Financial Regulation and Accreditation Standards Program to incorporate the licensing and review requirements as appropriate. This action will assure appropriate uniformity in company licensing and facilitate reciprocity among the States. As much of this work is well underway, the NAIC will implement the technology and uniform review initiatives, and draft the model act by December 2004.

Update: Once the Company Licensing Model Act has been completed and the NAIC sees States conforming, the model and Company Licensing Best Practices Handbook will be presented to the Financial Regulation Standards and Accreditation (F) Committee for consideration.

Solvency Regulation

Deference to lead States . . . State insurance regulators have recognized a need to more fully coordinate their regulatory efforts to share information proactively, maximize technological tools, and realize efficiencies in the conduct of solvency monitoring.

Deference to "Lead States"

Relying on the concept of "lead State" and recognizing insurance companies by group, when appropriate, the NAIC will implement procedures for the relevant domestic States of affiliated insurers to plan, conduct and report on each insurer's financial condition.

Update: The NAIC's Insurance Holding Company Working Group adopted the Examination Coordination Initiative during the 2005 Spring National Meeting. This initiative requires additional actions by the designated 'lead States' to proactively improve examination coordination, and requires communicating those coordination efforts to the NAIC on select groups.

In accordance with the Examination Coordination Initiative, each group has been classified into one of three categories to represent the coordination efforts expected for their upcoming exams. Within two categories, (Currently Coordinated Exams and Focused Coordination Efforts) States are required to coordinate exams in accordance with the lead States designated examination schedule. If coordination cannot be achieved, the non-lead must provide notification to the NAIC on the elements that hindered exam coordination and the efforts that will be taken to ensure coordination during the lead State's next planned examination date. For examinations within the third category (Other Exams to Coordinate), all States are requested to adhere to the lead State's planned examination schedule. However, as these groups are comprised of several companies domiciled in multiple States with various examination schedules, further time will be needed for complete coordination. As such, no notification requirement has been established for the groups within these categories.

In order to assist States in complying with the Examination Coordination Initiative, a new application is being developed within the Exam Tracking System (Examination Calendar) that will serve as a forum to collect information and notify other States about the lead State's planned examination schedules, and also to provide reports on the groups/companies that have been successful in coordinating with the lead State. In addition, this application will provide a forum for non-lead States to communicate regarding problems preventing exam coordination, as well as their efforts toward future coordination. This Examination Calendar application is expected to be available in 2006.

Additionally, in order to ensure that State coordination efforts are improving communication and examination efficiencies, the lead State and non-lead States will be requested to document in the examination work papers how they communicated and coordinated their efforts to improve examination efficiencies.

Financial Examinations

In regard to financial examinations, many insurers are members of a group or holding company system that has multiple insurers and that may have multiple States of domicile. These affiliated insurers often share common management along with claims, policy and accounting systems, and participate in the same reinsurance arrangements. Requirements for coordination of financial examinations will be set forth in the NAIC Financial Condition Examiners Handbook. To allow time for the States to adjust examination schedules and resources, such coordination will be phased in over the next 5 years, with the goal of full adherence to the Handbook's guidance for examinations conducted as of December 2008.

Update: The Financial Examiners Handbook (E) Technical Group revised the NAIC Financial Condition Examiners Handbook in the summer of 2005. The revisions provide guidance on the responsibilities common to the role of the lead State and non-lead States. These revisions also include the key elements of the Examination Coordination Initiative and the responsibilities of the States. As this Handbook is an NAIC Accreditation Standard, the Financial Regulation Standards and Accreditation (F) Committee will consider these changes in 2006.

In addition to the Examiners Handbook, the Financial Analysis Handbooks have also been revised. These revisions stress the need to maintain confidentiality of information, and refer to current confidentiality arrangements in place between each State and Federal banking agencies, State banking supervisors, and other functional regulators. Part of the lead State's role is to perform a review of the consolidated group, including analysis of the group's financial results and overall business strategy.

As previously mentioned, there are proposals to provide a new application so that the Exam Tracking System can serve as a forum to collect planned examination schedules and report on the groups/companies that are planned to be examined in accordance with 'as of' dates in order to improve coordination of exams. This 'examination calendar' became available in June 2006.

Insolvency Model Act

The NAIC will promote uniformity by reviewing the Insolvency Model Act, maximizing use of technology, and developing procedures for State coordination of imminent insolvencies and guaranty fund coverage. The Financial Regulation Standards and Accreditation (F) Committee will consider the requirements no later than January 1, 2008.

Update: In 2005, the NAIC adopted the Insurer Receivership Model Act (IRMA) as the foundation of modernization in the receivership area. IRMA is intended to comprehensively address the administration of an impaired or insolvent insurer from conservation and rehabilitation to liquidation and winding up of an estate. The Financial Condition (E) Committee and its working groups are developing and considering changes to the Property & Casualty Insurance Guaranty Association Model Act and model language addressing the administration of high deductible policies. It is also developing a recommendation for a proposed revision to the accreditation standard addressing receiverships. The Financial Regulation and Standards Accreditation (F) Committee is expected to address this issue in 2007. The NAIC will also be working on a revision to the Receivers' Handbook to incorporate the modernization provisions of IRMA.

The NAIC continues its efforts to make improvements in the automation of information and processes in the receivership area. The Global Receivership Information Data base continues to be enhanced and populated through the efforts of State insurance departments. The NAIC has developed a Uniform Receivership Internet Template to allow States to present minimum standard information to consumers

in a manner that is uniform from State to State. The NAIC is also developing a system for use by States in the administration of proof-of-claims.

Changes of Insurance Company's Control

Streamline the process for approval of mergers and other changes of control.

Coordination Using "Lead States"

Regulatory consideration of the acquisition of control or merger of a domestic insurer is an important process for guarding the solvency of insurers and protecting current and future policyholders. At the same time, NAIC members realize that these transactions are time sensitive and the process can be daunting when approvals must be obtained in multiple States. As a result, States will enhance their coordination and communication on acquisitions or mergers of insurers domiciled in multiple States by designing a system through which these multi-State reviews are coordinated by one or more "lead" States.

Update: As noted above (Section VI), regulators are in process of implementing the NAIC lead State framework.

Form A Database

Insurers are required to file for approval on documents referred to as Form A filings when mergers or acquisitions are being considered. The NAIC has created a data base to track these filings so that this information is available to all State regulators. Usage will be monitored to ensure that all States use the application to improve coordination of Form A reviews and to alert State regulators to problem filings. The Form A Review Guide and Form A Review Checklist, which contain procedures to be utilized when reviewing a Form A Filing, will be enhanced and incorporated into the existing NAIC Financial Analysis Handbook as a supplement. NAIC members will work on amending the Accreditation Program to include the Form A requirements to further promote stronger solvency standards and State coordination, as well as an efficient process for our insurers. The Form A requirements will be targeted for incorporation into the Accreditation Program no later than January 1, 2007.

Update: The NAIC's Form A Data base, initially released in March 2002, was designed to alert States to Form A filings from the same or similar individuals or entities in other States. Efforts continue to educate and inform regulators regarding the use and benefits of this data base system. Benefits occur largely in the area of coordinating on common Form A filings and identifying acquiring parties who are suspicious. A formal training program was developed and offered to States throughout 2004 and 2005.

The Insurance Holding Company Working Group adopted a revised Holding Company Analysis Framework during the 2005 Spring National Meeting. The revised Framework was referred to the Financial Analysis Handbook Working Group, which developed a Holding Company Analysis checklist and adopted it in October of 2005. The primary objective of this Holding Company Analysis Checklist is (A) to gain an overall understanding of the holding company structure or insurance group and how the insurance subsidiary fits into the organization, and (B) to assess the potential risks the holding company or other affiliates pose to the insurance subsidiary.

Integrate Policy Form Approval and Producer Licensing into the Merger and Acquisition Process

The NAIC members will develop procedures for the seamless transfer of policy form approvals and producer appointments to take place contemporaneously with the approval of mergers or acquisitions where appropriate. We will begin developing and testing these procedures through pilot programs in 2003 and fully incorporate them system wide by 2006.

Update: With regard to integrating policy form approval and producer licensing into the M&A process, two pilot projects have been completed. However, further work to develop a procedural manual has not been completed because the National Treatment and Coordination Working Group is focused on modernizing the company licensing process.

Attachment B

ATTACHMENT B

State Insurance Revenues - 2004

State	Calendar/ Fiscal Year	Total Revenues	Total Taxes	Fees and Assessments	Fines and Penalties	Other Revenue
Alabama	Fiscal	$254,943,321	$240,334,763	$14,541,721	$66,837	$0
Alaska	Fiscal	$49,349,460	$43,522,983	$5,414,361	$319,403	$92,713
Arizona	Fiscal	$316,490,500	$308,792,800	$7,102,300	$532,500	$62,900
Arkansas	Fiscal	$175,289,581	$149,507,860	$17,284,546	-	$8,497,175
California	Fiscal	$2,140,183,000	$1,949,975,000	$179,748,000	$5,859,000	$4,601,000
Colorado	Fiscal	$184,100,927	$177,780,767	$5,603,276	$716,884	$0
Connecticut	Fiscal	$149,204,289	$88,552,547	$22,106,525	$1,292,689	$37,252,528
Delaware	Fiscal	$82,199,023	$79,169,649	$2,689,234	$332,669	$7,471
Dist. of Columbia	Fiscal	$61,515,071	$47,452,132	$6,370,587	$2,968,491	$4,723,861
Florida	Fiscal	$708,779,716	$703,496,172	$4,305,757	$977,787	$0
Georgia	Fiscal	$666,159,494	$317,433,104	$327,409,091	$986,250	$20,331,049
Hawaii	Fiscal	$84,978,165	$78,142,253	$6,530,285	$90,175	$215,452
Idaho	Fiscal	$85,220,300	$78,391,700	$6,234,100	$162,000	$432,500
Illinois	Fiscal	$468,610,399	$385,068,337	$57,492,267	$2,755,522	$23,294,273
Indiana	Fiscal	$183,455,189	$178,303,092	$3,725,532	$350,285	$1,076,280
Iowa	Fiscal	$153,900,864	$138,241,481	$11,695,587	$3,963,796	$0
Kansas	Fiscal	$133,028,528	$106,864,427	$20,592,137	$81,157	$5,490,807
Kentucky	Fiscal	$247,118,520	$187,637,065	$29,372,520	$918,558	$29,190,377
Louisiana	Fiscal	$273,543,079	$200,345,177	$72,271,861	$627,644	$298,397
Maine	Fiscal	$88,211,519	$75,858,027	$11,014,760	$1,338,732	$0
Maryland	Fiscal	$284,853,917	$260,013,035	$23,760,721	$1,080,161	$0
Massachusetts	Fiscal	$434,708,114	$342,663,000	$63,781,253	$815,175	$27,448,686
Michigan	Fiscal	$29,304,718	$13,931,652	$15,002,739	$370,327	$0
Minnesota	Fiscal	$289,201,213	$273,639,673	$15,068,265	$493,275	$0
Mississippi	Fiscal	$162,751,578	$156,353,481	$6,074,605	$172,176	$151,316
Missouri	Calendar	$269,648,309	$251,305,851	$16,985,167	$1,343,656	$13,635
Montana	Fiscal	$61,294,627	$55,326,963	$5,737,279	$215,976	$14,409
Nebraska	Fiscal	$89,878,786	$79,279,739	$9,908,714	$147,036	$543,297
Nevada	Fiscal	$207,777,402	$194,457,058	$11,508,027	$627,649	$1,184,668
New Hampshire	Fiscal	$86,245,973	$79,450,354	$6,676,280	$119,339	$0
New Jersey	Fiscal	$498,556,000	$417,873,000	$77,987,899	$2,695,101	$0
New Mexico	Fiscal	$154,778,270	$145,178,196	$6,961,265	$325,336	$2,313,473
New York	Fiscal	$1,240,719,494	$1,019,000,820	$216,607,537	$5,111,137	$0
North Carolina	Fiscal	$481,491,129	$448,558,368	$30,170,191	$2,762,570	$0
North Dakota	Fiscal	$40,199,894	$30,928,373	$3,924,347	$29,689	$5,317,485
Ohio	Calendar	$507,173,780	$447,500,000	$58,919,631	$299,124	$455,025
Oklahoma	Fiscal	$193,183,568	$175,334,804	$17,339,050	$369,352	$140,362
Oregon	Calendar	$71,770,493	$61,945,444	$7,919,759	$357,733	$1,547,557
Pennsylvania	Fiscal	$433,590,500	$390,768,000	$40,446,000	$2,282,000	$94,500
Puerto Rico	Fiscal	$35,016,000	$27,154,000	$6,670,000	$602,000	$590,000
Rhode Island	Fiscal	$70,243,912	$43,349,584	$8,015,368	$120,991	$18,757,969
South Carolina	Fiscal	$149,677,404	$136,730,848	$12,673,825	$272,731	$0
South Dakota	Calendar	$64,065,578	$53,338,852	$10,592,037	$114,028	$20,661
Tennessee	Fiscal	$397,501,787	$359,013,756	$26,552,379	$875,964	$11,059,688
Texas	Fiscal	$1,258,533,257	$1,097,833,808	$156,713,797	$2,482,457	$1,503,195
Utah	Fiscal	$130,927,954	$123,577,128	$6,585,101	$374,447	$391,278
Vermont	Fiscal	$55,512,593	$49,016,995	$5,686,395	$0	$809,203
Virginia	Fiscal	$402,734,072	$351,613,236	$49,702,881	$1,201,885	$216,070
Washington	Fiscal	$373,932,843	$345,614,001	$26,093,432	$1,817,718	$407,692
West Virginia	Fiscal	$146,367,358	$139,646,087	$6,229,681	$491,590	$0
Wisconsin	Fiscal	$158,338,000	$138,388,000	$19,234,000	$291,000	$425,000
Wyoming	Calendar	$22,346,824	$16,044,781	$1,893,500	$62,779	$4,345,764
Total		**$15,308,606,292**	**$13,259,698,223**	**$1,782,925,572**	**$52,664,781**	**$213,317,716**
Percent of Total			**86.62%**	**11.65%**	**0.34%**	**1.39%**

Attachment C

ATTACHMENT C

Consumer Complaints/Inquiries - 2004

State	Consumer Complaints	Consumer Inquiries
Alabama	8,011	-
Alaska	459	7,600
Arizona	2,984	64,541
Arkansas	3,320	38,960
California	39,737	285,562
Colorado	5,206	43,268
Connecticut	11,004	25,464
Delaware	7,181	3,867
Dist. of Columbia	967	7,600
Florida	94,298	483,823
Georgia	17,387	66,618
Hawaii	661	8,000
Idaho	1,284	10,507
Illinois	14,180	146,268
Indiana	6,369	15,208
Iowa	2,431	16,220
Kansas	5,315	7,516
Kentucky	5,783	398
Louisiana	3,807	125,840
Maine	1,518	15,901
Maryland	23,272	1,181
Massachusetts	2,078	34,459
Michigan	4,771	7,055
Minnesota	3,051	1,329
Mississippi	15,000	-
Missouri	4,838	39,979
Montana	1,738	821
Nebraska	2,122	-
Nevada	2,303	42,598
New Hampshire	1,510	9,970
New Jersey	11,406	57,039
New Mexico	2,464	-
New York	55,097	1,726
North Carolina	11,910	76,933
North Dakota	311	9,669
Ohio	7,917	112,202
Oklahoma	5,744	40,588
Oregon	4,495	15,431
Pennsylvania	21,637	128,129
Puerto Rico	1,004	13,072
Rhode Island	705	-
South Carolina	3,124	60,523
South Dakota	1,186	38
Tennessee	549	-
Texas	30,866	984,642
Utah	674	46,403
Vermont	779	349
Virginia	5,896	1,349
Washington	5,874	98,464
West Virginia	2,099	26,406
Wisconsin	7,938	35,000
Wyoming	586	-
Total	**474,846**	**3,218,516**

Attachment D

ATTACHMENT D

Number of Insurers - 2004

State	Domestic Insurers	Licensed Foreign Insurers	Chartered Self-Insured Groups or Pools	Chartered Purchasing Groups
Alabama	52	1,348	-	7
Alaska	9	753	-	2
Arizona	355	1,519	19	21
Arkansas	70	1,457	0	3
California	190	1,367	-	60
Colorado	66	1,405	12	33
Connecticut	111	1,130	0	18
Delaware	135	1,321	-	485
Dist. of Columbia	61	1,349	0	233
Florida	587	1,610	155	6
Georgia	111	1,486	52	0
Hawaii	172	971	2	6
Idaho	22	1,400	0	2
Illinois	389	1,468	10	120
Indiana	175	1,640	0	6
Iowa	207	1,401	2	13
Kansas	52	1,597	18	260
Kentucky	55	1,500	315	31
Louisiana	135	1,452	25	183
Maine	31	1,038	20	2
Maryland	79	1,410	6	401
Massachusetts	91	1,102	25	10
Michigan	142	1,407	13	0
Minnesota	179	1,313	22	656
Mississippi	52	1,442	0	2
Missouri	225	1,395	0	0
Montana	35	1,380	0	4
Nebraska	109	1,459	5	3
Nevada	80	1,725	13	169
New Hampshire	40	932	0	5
New Jersey	109	1,195	48	27
New Mexico	18	1,418	4	0
New York	617	963	4	415
North Carolina	88	1,286	11	3
North Dakota	41	1,400	4	4
Ohio	266	1,519	-	317
Oklahoma	99	1,591	10	2
Oregon	143	1,571	0	5
Pennsylvania	304	1,483	22	18
Puerto Rico	53	295	-	-
Rhode Island	33	1,159	2	24
South Carolina	276	1,488	0	9
South Dakota	46	1,380	-	-
Tennessee	74	1,475	7	5
Texas	475	1,546	0	70
Utah	41	1,431	1	12
Vermont	546	903	3	3
Virginia	75	1,443	18	8
Washington	58	1,373	0	7
West Virginia	23	1,367	-	2
Wisconsin	374	1,552	0	81
Wyoming	5	1,392	0	1
Total	**7,789**	**-**	**848**	**3,754**
Average	**142**	**1,277**	**19**	**75**

Attachment E

ATTACHMENT E

Licensed Producers - 2004

	Individuals			Business Entities		
State	**Total**	**Resident**	**Non-Resident**	**Total**	**Resident**	**Non-Resident**
Alabama	65,029	30,016	35,013	3,858	2,482	1,376
Alaska	18,425	3,254	15,171	3,534	815	2,719
Arizona	93,722	36,528	57,194	7,316	2,569	4,747
Arkansas	43,585	15,652	27,933	4,128	1,739	2,389
California	267,314	200,184	67,130	14,526	9,730	4,796
Colorado	79,925	34,194	45,731	7,914	3,291	4,623
Connecticut	73,182	23,124	50,058	9,072	2,819	6,253
Delaware	41,848	4,927	36,921	4,621	817	3,804
Dist. of Columbia	27,529	727	26,802	3,008	86	2,922
Florida	353,444	219,135	134,309	25,211	24,451	760
Georgia	102,873	52,908	49,965	9,563	6,430	3,133
Hawaii	18,278	6,102	12,176	1,265	412	853
Idaho	36,796	7,894	28,902	4,402	799	3,603
Illinois	144,532	79,713	64,819	12,375	-	-
Indiana	112,531	55,393	57,138	9,169	3,715	5,454
Iowa	61,260	25,490	35,770	1,945	244	1,701
Kansas	67,788	22,721	45,067	8,253	3,285	4,968
Kentucky	82,738	25,314	57,424	5,243	2,176	3,067
Louisiana	61,190	30,275	30,915	5,581	2,724	2,857
Maine	44,932	7,153	37,779	5,181	949	4,232
Maryland	85,608	32,363	53,245	7,876	2,973	4,903
Massachusetts	65,635	32,457	33,178	3,902	2,486	1,416
Michigan	123,235	50,986	72,249	13,429	7,016	6,413
Minnesota	84,814	43,792	41,022	7,226	-	-
Mississippi	74,356	33,863	40,493	5,244	-	-
Missouri	95,670	44,548	51,122	12,067	5,905	6,162
Montana	30,423	6,711	23,712	6,641	2,325	4,316
Nebraska	45,262	16,386	28,876	6,957	2,268	4,689
Nevada	58,180	16,339	41,841	7,348	2,741	4,607
New Hampshire	32,921	5,764	27,157	3,778	706	3,072
New Jersey	112,386	53,367	59,019	10,883	5,043	5,840
New Mexico	57,327	15,806	41,521	3,044	686	2,358
New York	193,318	128,567	64,751	21,394	17,114	4,280
North Carolina	124,297	68,834	55,463	6,160	3,486	2,674
North Dakota	30,913	6,103	24,810	2,410	602	1,808
Ohio	201,213	86,519	114,694	14,403	9,220	5,183
Oklahoma	55,111	19,084	36,027	5,648	1,649	3,999
Oregon	57,724	19,114	38,610	7,647	2,780	4,867
Pennsylvania	138,545	67,434	71,111	12,672	8,952	3,720
Puerto Rico	5,366	5,366	0	240	189	51
Rhode Island	24,900	4,310	20,590	4,050	505	3,545
South Carolina	72,322	29,557	42,765	5,519	2,749	2,770
South Dakota	34,201	8,425	25,776	2,578	-	-
Tennessee	98,471	55,596	42,875	2,171	897	1,274
Texas	200,204	135,241	64,963	10,536	7,949	2,587
Utah	48,631	14,244	34,387	5,242	1,940	3,302
Vermont	29,875	3,142	26,733	782	51	731
Virginia	113,409	50,351	63,058	11,301	5,063	6,238
Washington	72,389	33,312	39,077	13,670	7,539	6,131
West Virginia	38,724	9,806	28,918	3,036	706	2,330
Wisconsin	88,203	40,910	47,293	2,277	560	1,717
Wyoming	23,783	2,599	21,184	4,355	516	3,839
Total	**4,314,337**	**2,021,600**	**2,292,737**	**370,651**	**174,149**	**169,079**

PREPARED STATEMENT OF JOHN D. JOHNS

CHAIRMAN, PRESIDENT, AND CEO, PROTECTIVE LIFE CORPORATION

JULY 11, 2006

Mr. Chairman and Members of the Committee, my name is Johnny Johns, and I am President and Chief Executive Officer of Protective Life Insurance Company. I am appearing today on behalf of the American Council of Life Insurers. The ACLI is the principal trade association for U.S. life insurance companies, and its 377 member companies account for approximately 90 percent of life insurance premiums, 95 percent of annuity considerations and 91 percent of the industry's total assets.

I appreciate the opportunity to appear before you today to discuss the current framework for regulating the life insurance business in the United States and to present our views on ways in which that framework can and should be modernized. Each year the ACLI surveys its board of directors to establish the organization's advocacy priorities, and once again this year regulatory modernization tops the list. This is a critically important issue for the life insurance business, and on behalf of my company as well as the ACLI and its other member life insurers, I want to thank you for holding this hearing and placing insurance regulatory modernization on the Committee's agenda.

The fundamental point I would like to make today is quite simple. As the business of insurance has evolved over the years from an enterprise that was largely local in nature to a $4.5 trillion industry that is predominantly national and increasingly global in scope, the accompanying system of regulation has failed to keep pace. As a consequence, insurers are significantly handicapped in their ability to compete efficiently and serve the best interests of their consumers.

Today's Life Insurance Business and the Importance of Efficient Regulation

From the outset, I want to make it clear that, while we believe the regulatory framework of our current State-based system is inefficient and unresponsive to the needs of today's marketplace, we appreciate very much the highly professional and competent regulators who work within that system. In the many instances in which I have had the privilege to work with State regulators, I have been impressed with their diligent and conscientious efforts to protect policyholders and ensure insurer solvency. Their job is not an easy one, especially when they must regulate, not only within their own State law, but in some cases also cooperatively within the laws of their fellow regulators in other States. This testimony would not be complete without a sincere recognition of the remarkable contributions that are made by the regulators under such a challenging regulatory structure.

The present State-based system of insurance regulation was instituted at a time when "insurance" was not deemed to be interstate commerce. Consequently, the underpinnings of that system—which remain pervasive today—contemplate doing business only within the borders of a single State. Today, most life insurers do business in multiple jurisdictions if not nationally or internationally. In short, our system of regulation has failed to keep pace with changes in the marketplace, and there is a wide gap between where regulation is and where it needs to be.

Life insurers today provide an array of unique products and services that benefit Americans in all stages of life with products like life insurance, annuities, disability income insurance and long-term care insurance. These products not only protect a family's finances, but also enable Americans to save money, accumulate wealth for retirement and convert it into a guaranteed lifetime stream of retirement income. No other financial intermediary can do that.

Currently, there are over 373 million life insurance policies in force, providing Americans with $18.4 trillion in financial protection. In addition, Americans have saved $2.2 trillion toward their retirement by investing through our annuity products. Our long-term commitments and investments place us as one of the largest investors in the U.S. economy assisting in economic growth. In managing these obligations, the life insurance industry has invested $4.3 trillion in the financial markets, representing 9 percent of the total capital. Life insurers are one of the largest holders of long term, fixed rate commercial mortgages in the United States. These long-term financial commitments are generally 10 years and longer in maturity, much longer than commitments made by other financial intermediaries.

Life insurers are also a vital component of the U.S. economy. Fifty-one percent of the industry's assets, or $3.6 trillion, are held in long-term bonds, mortgages, and real estate. This includes: $512 billion invested in Federal, State and local government bonds, helping to fund urban revitalization, public housing, hospitals, schools, airports, roads and bridges; $295 billion invested in mortgage loans on real estate financing for homes, family farms and offices; $1.5 trillion invested in long-term U.S. corporate bonds. Twenty-nine percent of the industry's assets, $1.3 trillion, are invested in corporate stocks.

Beyond this significant investment we make in the economy, it is in the area of long-term savings and retirement security that life insurance may have the greatest positive impact on public policy in the coming years. With 76 million baby boomers nearing retirement, the United States faces a potential retirement crisis. We must confront the fact that the average American nearing retirement has only $78,000 in savings and assets, not including real estate. Industry research indicates that 65 percent of Americans believe they will not be able to save enough for retirement.

Future retirees will have fewer sources of guaranteed income than previous generations due to the decline of traditional defined benefit pension plans and the fact that Social Security, on average, replaces only 42 percent of earnings. If nothing is done, there is a real possibility that millions of Americans will outlive their retirement assets.

The life insurance industry is uniquely positioned to help American workers prepare for their financial futures. Our business continues to be a prominent resource in helping both large and small employers provide the right qualified retirement or savings plan for their employees. Insurers act as asset managers or administrators for defined benefit, 401(k), 403(b) 457 plans and other tax-qualified arrangements.

However, for the life insurance business to remain viable and serve the needs of the American public effectively, our system of regulation must become far more efficient and responsive to the needs and circumstances of a 21st century global business. Life insurers today operate under a patchwork system of State laws and regulations that lack uniformity and are applied and interpreted differently from State to State. The result is a system characterized by delays and unnecessary expenses that hinder companies and disadvantage their customers. We believe it is appropriate, and we are asking for your help, to modernize our regulatory structure to ensure that we are able to continue to serve our customers in the most efficient and effective way.

Lack of Uniformity Hampers Multi-State Life Insurers

A significant impediment for multi-State insurers is the current State-based system's inability to produce, in crucial areas, both uniform standards and consistent application of those standards by the States. I'd like to give you a brief outline of the business and regulatory complexities commonly faced by life insurers under the current system.

Before a company can conduct any activities, it must apply for a license from its "home" or "domestic" State insurance department. A license will be granted if the company meets the domestic State's legal requirements, including capitalization, investment and other financial requirements. If the company wishes to do business only in its home State, this one license will be sufficient. However, in order to sell products on a multi-State basis, a company must apply for licenses in all the other States in which it seeks to do business. Each additional State may have licensing requirements that deviate from those of the company's home State, and the company will have to comply with all those different requirements notwithstanding the fact that the home State regulator will remain primarily responsible for the insurer's financial oversight.

Once a company has all its State licenses in hand, it can turn its attention to selling policies. To do that, a company must first file each product it wishes to market in a particular State with that State's insurance department for prior approval. A company doing business in all States and the District of Columbia must, for example, file the same policy form 51 different times and wait for 51 different approvals before selling that product in each jurisdiction. And this process must be repeated for each product the insurer wishes to offer. Since these 51 different insurance departments have no uniform standards for the products themselves or for the timeliness of response for filings, a company may receive approval from one or two jurisdictions in 3 months, from another ten jurisdictions in 6 months, and may have to wait 18 months or longer to receive approval from all jurisdictions.

This process is further complicated by the fact that each insurance department may have its own unique "interpretation" of State statutes, even those that are identical to the statutes in other jurisdictions. As a result, a company will be required to "tweak" its products in order to comply with each individual department's "interpretation" of what otherwise appeared to be identical law. Since a company has to refile each product after it has been "tweaked," the time lapse from original filing to final approval can very well be double that which was originally expected. And, as a result of the various "tweaks," what started out as a single product may wind up as thirty or more different products.

After a company has received approval to sell its products in a State, it needs a sales force to market those products. Here again we encounter the inefficiencies of the current State system. Each State requires that anyone wishing to act as an insurance agent first be licensed as such under the laws of that State. Each State has its own criteria for granting an agent's license, and these criteria include differing continuing education requirements once the license is issued. Like companies, insurance agents wishing to work with clients in more than one State must be separately licensed by the insurance departments in each of those States. And, because of the differing State form filing requirements for companies noted above which results in products being "tweaked" for approval in each of the various jurisdictions, persons

granted agent licenses by more than one State will not always have the ability to offer all clients the same products.

After this multitude of licenses and approvals has been secured, a company can begin to sell products nationwide. However, the lack of uniformity in standards and application of laws will continue to be a complicated and costly regulatory burden that the company must constantly manage. The very basic things that any business must do to be successful—such as employing an advertising campaign, providing systems support, maintaining existing products, introducing new products and keeping a sales force educated and updated—are all affected by 51 different sets of laws, rules and procedures.

Add to this the fact that States also police actual marketplace activity by subjecting a company to market conduct examinations by the insurance departments of the States in which it is licensed. Even though State market conduct laws nationwide are based on the same NAIC model laws, there is minimal coordination of these exams among the various States. As a result, a company licensed to do business in all jurisdictions is perpetually having States initiate market conduct examinations just as one or more other States are completing theirs, with the cost of each exam being borne by the company—and ultimately its policyholders. And, because these examinations are largely redundant, the benefits derived relative to the costs incurred are marginal at best.

This tendency of the States to eschew uniformity, even when developed through the NAIC, may soon play itself out in the need to reform the reserving methodology used by our industry. The formulaic approach currently mandated by State law is outdated and out of step with more robust methodology used in, among others, European countries and Canada. The current formulaic approach adds significant costs to many of our products. Therefore, our products are unnecessarily expensive, and consumers are adversely affected. Although the NAIC is currently working to address the reserve problem, the structure of the State-based system is inherently a significant impediment. This is the case because each State has the ability to regulate the standards by which the statutory reserves are established for insurers doing business in that State. If one State refuses to enact reform, the insurers doing business in that State are subject to the outdated regulation, even if all other States enact the reform. In other words, each State has veto power. If a State with a particularly large population is the State that refuses to enact the reform, as a practical matter that State's law will be the governing law for all multistate carriers. Again, notwithstanding the efforts of outstanding regulators at the State level, the very structure of the system is the impediment.

I cannot overemphasize that the current regulatory system results in unnecessary costs that, of necessity, are passed on to the consumer. Today, every dollar spent on life insurance purchases less in coverage than it should, due to the unnecessary cost of the current regulatory system.

Competitiveness is restrained by the current system. The current regulatory process creates unnecessary barriers to entry. Due to the unnecessary costs imposed by the regulatory structure, equity investors seeking an adequate return on capital are discouraged. Product innovation is impeded by the regulatory structure, resulting in fewer choices for consumers.

ACLI Policy on Insurance Regulatory Modernization: State and Federal Solutions

The ACLI Board of Directors, after careful consideration and extensive discussion with member life insurance companies—large and small—determined to approach improving regulatory efficiency and modernization on two tracks. One is to work with the States and the NAIC to improve a State-based system of regulation. The other is to work with Congress to put in place a Federal charter option for life insurers and insurance producers.

While my remarks today focus on the need for a comprehensive Federal solution to modernizing the insurance regulatory framework, I would be remiss if I did not compliment the NAIC and the States for the substantial progress they have made on developing an interstate compact for expediting the filing and approval of life insurance products. Recently, more than half the States enacted the compact legislation, meaning that the compact commission—the body that will actually handle product filings and approvals—can now be established and made operational. Until all States, and certainly all States with significant populations, become part of this compact mechanism, the full benefits of this initiative will not be realized.

The ACLI is fully committed to the interstate compact concept and is working with State regulators and legislators to pass legislation necessary to have every State become a part of this mechanism. However, it must be understood that the NAIC's interstate compact addresses only a single issue—getting new products filed,

approved and into the marketplace in a timely manner. It does not address the many other areas in which lack of uniformity in law or regulation from State to State affects the ability of life insurers to provide their customers with products and services in a timely and efficient manner. Other issues that are in need of modernization include: reserving; coordination of market conduct examinations; company licensing; producer licensing; quantitative investment limitations; nonforfeiture laws; State taxation of life insurers; replacements; reinsurance; and national advertising programs. The interstate compact has no effect on any of these issues, and that fact points out why the ACLI believes it is imperative for Congress to move forward with an optional Federal charter as the most appropriate comprehensive solution to regulatory reform.

S. 2509

The ACLI is extremely encouraged to see the introduction by Senators Sununu and Johnson ofS. 2509, the National Insurance Act of2006. This is a comprehensive approach to insurance regulatory reform and one that ACLI strongly supports.

Of course, we understand it is early in the process. ACLI and its member companies look forward to working with this committee on the mechanics of this legislation and making additional changes to refine it as the legislation moves forward.

One of the fundamental values of a Federal charter option such as that provided by S. 2509 is that it can achieve uniformity of insurance laws, regulation and interpretations the moment it is put into place. And only Congress can enact legislation that has this broad-based, immediate effect. Many life insurers believe that regulatory modernization is nothing short of a survival issue, and in that context the speed with which progressive change takes place is critical. Today's marketplace is intolerant of inefficient competition, and the prospect of having to wait years for the States to address individually the many areas in which efficiency of regulation must be improved is not encouraging.

We believe it is appropriate for Congress to focus its attention on a global, comprehensive alternative to State insurance regulation as provided by S. 2509. This measure meets the needs and circumstances of today' s national and multinational life insurers and will enable them to much more effectively serve the needs of Americans in need of life insurance protection and retirement financial security.

Unfounded Criticisms of the Optional Federal Charter

Critics of S. 2509 and the optional Federal charter it provides have made several unfounded allegations that we would like to address in this statement.

States Rights—S. 2509 is not an attack on States rights. Insurance is the only segment of the U.S. financial services industry that does not have a significant Federal regulatory component. Under S. 2509, the States would retain a significant a role in insurance regulation as their State regulatory counterparts now have in the banking and securities industries.

S. 2509 does not mandate Federal insurance regulation of all insurers. Rather, it allows an insurance company the option of seeking a Federal charter if company management believes that to be more complementary to the company's structure, operations or strategic plan.

It is not an affront to States' rights to seek the elimination of conflicting or inconsistent State laws. A principal objective of S. 2509 is to reduce the regulatory burden caused by such conflicts and redundancies and to do so by adopting the best State laws and regulations as the applicable Federal standards.

A further objective of S. 2509 is to modernize the insurance regulatory framework and, in so doing, make insurers significantly more competitive in the national and global marketplace. Enhancing competition is a sound and legitimate role for Congress and substantially outweighs concerns over any diminution of the regulatory role of the States.

Regulatory Arbitrage—Some have suggested that S. 2509 will lead to regulatory arbitrage and a "race to the bottom" as companies seek increasingly lax regulation and regulators rush to accommodate. From our perspective, nothing could be further from the truth.

First and foremost, the ACLI and its member companies are not seeking to migrate to a Federal system of insurance regulation that is lax. S. 2509 provides for a strong system of life insurance regulation that draws on the best existing State laws or NAIC model laws. It does not free life insurers from strong solvency regulation and consumer protection.

Second, the notion that adding one more system of regulation on top of the 51 that already exist will somehow give rise to regulatory arbitrage is groundless. Today, companies have the right in virtually all jurisdictions to change their State of domicile—that is, to move to a different State that would have primary responsi-

bility for the company's financial oversight. Consequently, there are 51 opportunities for regulatory arbitrage today.

The Federal regulatory option made available by S. 2509 is at least as strong as the better—if not the best—state system. How, then, would the enactment of this legislation create some new opportunity for this dreaded "race-to-the-bottom?" What possible harm would come from companies moving to a Federal system of regulation that is as strong as, if not stronger than, the one they are leaving?

Inherent in this assertion of possible regulatory arbitrage is the notion that a company executive could wake up one morning and simply decide to flip a company's charter. Quite simply, business does not work that way. Such a change carries with it countless significant consequences and considerations and is not entered into lightly. It is costly, time consuming and initially highly disruptive. The notion of regulatory arbitrage implies that companies would be inclined to move into and out of regulatory systems on a whim or whenever decisions were made or likely to me made that would be adverse to their interests. In the real world, this does not and would not occur.

The Federal Charter Is Optional—S. 2509 provides for a Federal charter option. It in no way mandates that companies be federally regulated. Companies that do a local business or that for other reasons would prefer to remain exclusively regulated by the States are perfectly free to do so. As we read S. 2509, is appears to be "charter neutral" in that it does not create tax or other unnecessary advantages relative to State chartered competitors.

While individual motives may vary, ACLI member life insurance companies are strongly united in their support for an optional Federal charter. Some feel that a Federal charter is in the long-term best interest of their company and its customers. Others have indicated that while they intend to remain State chartered even if a Federal charter were available to them, they see the threat of the Federal charter option providing motivation to the States to continue their efforts to enhance the efficiencies of State regulation.

State Premium Tax Revenues—Critics of S. 2509 and the optional Federal charter have suggested that if such an option were to become a reality, national insurers would somehow over time escape State premium taxes, which constitute a significant source of revenue for all States. This concern is totally unfounded.

As this Committee knows better than most, with the exception of Government Sponsored Enterprises, all for-profit federally chartered financial institutions such as commercial banks, savings banks and thrifts pay State income taxes. For insurers, this State tax obligation takes the form of a State premium tax. There is no precedent for, nor is there any expectation of, exclusion from the authority of the States to levy a premium tax. Indeed, S. 2509 expressly recognizes the States' authority to tax national insurers.

Consumer Protections—While critics have argued that consumer protections would suffer under an optional Federal charter, we believe a careful reading of S. 2509 suggest quite the contrary. By drawing on strong individual State laws or NAIC model laws, S. 2509:

- Guarantees that consumers are protected against company insolvencies by extending the current successful State-based guaranty mechanism to national insurers and their policyholders.
- Ensures the financial stability of national insurers by requiring adherence to statutory accounting principles that are more stringent (conservative) than GAAP.
- Duplicates the stringent investment standards currently required under State law.
- Mirrors the strong risk-based capital requirements of State law to ensure companies have adequate liquid assets.
- Duplicates State valuation standards that ensure companies have adequate reserves to pay consumers' claims when they come due.
- Mirrors the existing nonforfeiture requirements under State law that guarantee all insureds receive minimum benefits under their policies.

S. 2509 then goes further than many states by providing for:

- A Division of Insurance Fraud
- A Division of Consumer Affairs
- An Office of the Ombudsman
- Financial and market conduct examinations at least once every 3 years

In addition, consumers who deal with national insurers established pursuant to S. 2509 would enjoy significant added protections and benefits over those afforded by the States. For example, consumers will experience uniform and consistent protections nationwide and will enjoy the same availability of products and services in all 50 States. Consumers will also benefit from uniform rules regarding sales and marketing practices of companies and agents, and for the first time consumer issues of national importance will receive direct attention from a Federal regulator.

Conclusion

Mr. Chairman and Members of the Committee, I again thank you for recognizing the importance and urgency of insurance regulatory modernization and placing this critical issue on the agenda of this Committee. My company, the ACLI and its member companies look forward to working with you in the months ahead to address in a timely, appropriate and comprehensive manner the critical issue of modernizing this country's insurance regulatory system.

PREPARED STATEMENT OF THOMAS MINKLER

PRESIDENT, CLARK-MORTENSON AGENCY, INC.

JULY 11, 2006

Good afternoon Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. My name is Tom Minkler, and I am pleased to be here today on behalf of the Independent Insurance Agents and Brokers of America (IIABA) and to provide our association's perspective on insurance regulatory reform. I am currently Chairman of the IIABA Government Affairs Committee. I am also President of Clark Mortenson, a New Hampshire-based independent agency that offers a broad array of insurance products to consumers and commercial clients in New England and beyond.

IIABA is the Nation's oldest and largest trade association of independent insurance agents and brokers, and we represent a network of more than 300,000 agents, brokers, and employees nationwide. IIABA represents small, medium, and large businesses that offer consumers a choice of policies from a variety of insurance companies. Independent agents and brokers offer a variety of insurance products—property, casualty, health, employee benefit plans and retirement products.

Introduction

IIABA believes it is essential that all financial institutions be subject to efficient regulatory oversight and that they be able to bring new and more innovative products and services to market quickly to respond to rapidly evolving consumer demands. It is clear that there are inefficiencies existing today with insurance regulation, and there is little doubt that the current State-based regulatory system should be reformed and modernized. At the same time however, the current system does have great strengths—particularly in the area of consumer protection. State insurance regulators have done an excellent job of ensuring that insurance consumers, both individuals and businesses, receive the insurance coverage they need and that any claims they may experience are paid. These and other aspects of the State system are working well. The "optional" Federal charter concept proposed by some would displace these well-running components of State regulation and, in essence, "throw the baby out with the bathwater."

As we have for over 100 years, IIABA supports State regulation of insurance—for all participants and for all activities in the marketplace, and we oppose any form of Federal regulation—optional or otherwise. Yet despite this historic and long-standing support for State regulation, we are not confident that the State system will be able to resolve its problems on its own. That is why we feel that there is a vital legislative role for Congress to play in helping to reform the State regulatory system; however, such an effort need not replace or duplicate at the Federal level what is already in place at the State level. IIABA supports targeted, Federal legislation along the lines of the NARAB provisions of the Gramm-Leach-Bliley Act (GLBA) to improve the State-based system.

To explain the rationale for this approach, I will first offer an overview of both the positive and negative elements of the current insurance regulatory system. I will then outline the reasons for our strong opposition to an optional Federal charter; and specifically our opposition to S. 2509, the National Insurance Act of 2006. I will then describe the NARAB provisions of GLBA and provide a more complete explanation of IIABA's support for targeted Federal legislation to modernize the State-based regulatory system.

The Current State of Insurance Regulation

From the beginning of the insurance business in this country, it is the States that have carried out the essential task of regulating the insurance marketplace to protect consumers. The current State insurance regulatory framework has its roots in the 19th century with New Hampshire appointing the first insurance commissioner in 1851, and insurance regulators' responsibilities have grown in scope and complexity as the industry has evolved. When a Supreme Court decision raised questions about the role of the authority of the States, Congress quickly adopted the McCarran-Ferguson Act [1] (McCarran-Ferguson) in 1945. That act, which was reaffIrmed by Congress in 1999, declared that States should regulate the business of insurance and that the continued regulation of the insurance industry by the States was in the public's best interest.

GLBA expressly states that McCarran-Ferguson remains the law of the United States and further states that no person shall engage in the business of insurance in a State as principal or agent unless such person is licensed as required by the appropriate insurance regulator of such State. Title III also unequivocally provides that "[t]he insurance activities of any person (including a national bank exercising its powers to act as agent . . .) shall be functionally regulated by the States," subject only to certain exceptions which are intended to prevent a State from thereby frustrating the new affiliation policy adopted in GLBA. These provisions collectively ensured that State insurance regulators retained regulatory authority over all insurance activities, including those conducted by financial institutions and their insurance affiliates. These mandates were intended in large part to draw the appropriate boundaries among the financial regulators, boundaries that unfortunately continue to be challenged.

Most observers agree that State regulation has worked effectively to protect consumers, largely because State officials are positioned to be responsive to the needs of the local marketplace and local consumers. Unlike most other financial products, the purchaser of an insurance policy will not be able to fully determine the value of the product purchased until after a claim is presented—when it is too late to decide that a different insurer or a different product might make a better choice. As a result, insurance is a product with which consumers have many issues and questions and if a problem arises they want to resolve it quickly and efficiently with a local call. In 2002 State insurance regulators handled approximately 4.2 million consumer inquiries and complaints. Today, State insurance departments employ approximately 13,000 individuals who draw on over a century-and-a-half of regulatory experience to protect insurance consumers.

Unlike banking and securities, insurance policies are inextricably bound to the separate legal systems of each State, and the policies themselves are contracts written and interpreted under the laws of each State. When property, casualty, and life claims arise, their legitimacy and amounts must be determined according to individual State legal codes. Consequently, the constitutions and statue books of every State are thick with language laying out the rights and responsibilities of insurers, agents, policyholders, and claimants. State courts have more than 100 years of experience interpreting and applying these State laws and judgments. The diversity of underlying State reparations laws, varying consumer needs from one region to another, and differing public expectations about the proper role of insurance regulation require local officials "on the beat."

Protecting policyholders against excessive insurer insolvency risk is one of the primary goals of insurance regulation. If insurers do not remain solvent, they cannot meet their obligations to pay claims. State insurance regulation gets high marks for the financial regulation of insurance underwriters. State regulators protect policyholders' interests by requiring insurers to meet certain financial standards and to act prudently in managing their affairs. The States, through the National Association of Insurance Commissioners (NAIC), have developed an effective accreditation system for financial regulation that is built on the concept of domiciliary deference (the State where the insurer is domiciled takes the lead role). When insolvencies do occur, a State safety net is employed: the State guaranty fund system. States also supervise insurance sales and marketing practices and policy terms and conditions to ensure that consumers are treated fairly when they purchase products and file claims.

Despite its many benefits, State insurance regulation is not without its share of problems. The shortcomings of State regulation of insurance fall into two primary categories-it simply takes too long to get a new insurance product to market, and

[1] McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§1011–1015 (1994)).

there is unnecessary duplicative regulatory oversight in the licensing and post-licensure auditing process.

In many ways, the "speed-to-market" issue is the most pressing and the most vexing from a consumer perspective because we all want access to new and innovative products that respond to identified needs. Today, insurance rates and policy forms are subject to some form of regulatory review in nearly every State, and the manner in which rates and forms are approved and otherwise regulated can differ dramatically from State to State and from one insurance line to the next. Such requirements are significant because they not only affect the products and prices that can be implemented, but also the timing of product and rate changes in today's competitive and dynamic marketplace. The current system, which may involve seeking approval for a new product or service in up to 55 different jurisdictions, is too often inefficient, paper intensive, time-consuming, and inconsistent with the advance of technology and regulatory reforms made in other industries. In order to maximize consumer choice in terms of the range of products available to them, changes and improvements are needed.

Similarly, insurers are required to be licensed in every State in which they offer insurance products, and the regulators in those States have an independent right to determine whether an insurer should be licensed, to audit its market-conduct practices, to review mergers and acquisitions, and to outline how the insurer should be governed. It is difficult to discern how the great cost of this duplicative regulatory oversight is justified. (For a discussion of the need for agent licensing reform please see NARAB section.)

Federal Chartering

There is growing consensus among observers, including State and Federal legislators, regulators, and the insurance marketplace—that insurance regulation needs to be updated and modernized. There is disagreement, however, about the most effective and appropriate way in which to obtain needed reforms. Some support pursuing reforms in the traditional manner, which is to seek legislative and regulatory improvements on an ad hoc basis in the various State capitals. A second approach, pursued by several international and large domestic companies, calls for the unprecedented establishment of full-blown Federal regulation of the insurance industry. This call for an optional Federal charter concerns me deeply. Although the proposed optional Federal charter regulation might correct certain deficiencies, the cost is incredibly high. The new regulator would add to the overall regulatory infrastructure—especially for independent insurance agents and brokers selling on behalf of both State and federally regulated insurers—and undermine sound aspects of the current State regulatory regime.

The best characteristics of the current State system from the consumer perspective would be lost if some insurers were able to escape State regulation completely in favor of wholesale Federal regulation. As insurance agents and brokers, we serve on the front lines and deal with our customers on a face-to-face basis. Currently, when my customers are having difficulties with claims or policies, it is very easy for me to contact my local company representative or a local official within the State insurance department to remedy any problems. If insurance regulation is shifted to the Federal Government, I would not be as effective in protecting my consumers, as I have serious reservations that some Federal bureaucrat on a 1-800 number will be as responsive to a consumer's needs as a local regulator. The Federal regulatory model proposes to charge a distant (and likely highly politicized) Federal regulator with implementation and enforcement. Such a distant Federal regulator may be completely unable to respond to insurance consumer claims concerns. As a consumer, personal or business, there would be confusion as to who regulates their policy, the Federal Government or the State insurance commissioner. I could have a single client with several policies with one company that is regulated at the Federal level, while at the same time having several other policies which are regulated at the State level.

S. 2509, the National Insurance Act

On April 5, 2006, Senators John Sununu (R-NH) and Tim Johnson (D-SD) introduced S. 2509, the National Insurance Act of 2006 (NIA), a wide-reaching Federal regulatory insurance bill that creates an optional Federal charter for both the life and pic marketplaces. The bill would create a parallel, Federal system of regulation and supervision for insurers and producers, ostensibly modeled on the system for banks.

Insurers choosing to become federally regulated would be regulated primarily by a new Federal Office of National Insurance, patterned largely on the Office of the Comptroller of the Currency (OCC). The office would be within the Treasury Depart-

ment and be headed by a Commissioner appointed by the President. The NIA would also establish a National Insurance Guaranty Corporation (NIGC). National insurers would be required to participate in the respective life or pic guaranty funds in "qualified" States. For business written in "non-qualified" states, national insurers would be required to participate in the new NIGC. The bill requires national property casualty insurers to file nothing more than a list of standard policy forms annually with the Commissioner, but does not call for any rate or form approval of pic products, or even disclosure to the Commissioner of non-standard pic forms.

The NIA authorizes the chartering and licensing of national insurance agencies and the licensing of Federal insurance producers. The NIA authorizes a national insurance agency to sell insurance for any federally chartered or State licensed insurer and would permit federally licensed producers to sell insurance on behalf of any insurer nationwide, whether the insurer is federally licensed or state licensed. The bill would also prevent a State insurance regulator from restricting the ability of a State-licensed producer to sell insurance on behalf of a national insurer in the State in which the producer is licensed, but it does not expressly grant any regulator the power to regulate relationships between State licensed producers and national insurers.

Although the sponsors' statement suggests that they do not contemplate a requirement for producers to obtain a Federal license to deal with national insurers, it is unclear whether the Commissioner's authority to require such producers to become federally licensed might be inferred from any other provisions of the bill (or conversely, whether the Commissioner might forbid national insurers from dealing with producers who lack a Federal license). Despite the sponsors' statement this lack of clarity could lead to duplicative Federal licensing requirements. Even if the sponsors' intentions are realized the ensuing regulatory gap could eventually lead to additional Federal licensing requirements for those producers choosing to remain at the State level.

The Big "I" believes that S. 2509 creates an environment in which the State system could not survive. The sponsors of the NIA assert that this bill will create a healthy regulatory competition that will force State regulators to cooperate and be more receptive of the role of market forces. NIA proponents point to the dual banking system as an example of how this would work, but this is an incomplete analogy. In the banking context, the FDIC stands as the ultimate guarantor and protector of the public's trust in the entire banking system—both State and Federal. NIA lacks the same foundation in which both a State and Federal system can prosper. It creates an uneven playing field and will mark the beginning of the end of the State insurance regulatory system.

While it is alleged that the banking regulatory system is the model for the NIA, the bill bears only superficial resemblance to the national chartering of commercial banks. The so-called dual banking system itself is in reality multi-headed and was developed not by design but piece meal, beginning in the Civil War years; it would not be replicated today if we had a fresh start. At any rate, the NIA omits many of the most significant structural (and prudential) features of the banking model—it creates an OCC without the FDIC and the Fed playing their important supervisory roles. The NIA cherry-picks the features from several of these Federal banking laws to come up with a model which lacks the consumer protections found in anyone of them, and which ignores the problems it would create for State insurers, guaranty funds, and their citizens.

This proposal turns the dual-banking model, which proponents profess to admire, on its head. It is as if the FDIC's guaranty function was returned to State-managed individual deposit insurance funds, and then these State funds were forced by Congress to insure both national banks and State chartered banks, but without the States having any supervisory authority over the national banks. The FDIC guarantees the deposits of both State and national banks. However, since the S&L and banking crises of the 1980s the FDIC has exercised enhanced regulatory powers as a supervisory backstop in order to protect the guaranty funds. Under the NIA, the State guaranty funds paradoxically would be encouraged to play the FDIC's role as guarantors of National Insurers but would be denied the auditing or solvency supervision over these insurers which the FDIC enjoys over all insured banks. This scheme is not only the reverse of the banking system, but it imprudently separates the solvency guarantee function from the financial risk supervision of the new National Insurers. Also lacking in the discretionary supervision created by the NIA is the discipline of "prompt corrective action" that is a necessary component to protect the FDIC guaranty funds.

This could have disastrous implications for solvency regulation which ensures that companies meet their obligations to consumers by largely bifurcating this key regulatory function from guaranty fund protection. The FDIC (or Federal Reserve) exer-

cises significant solvency supervisory authority over all insured institutions, whether State or nationally chartered, that is, every bank has at least two layers of regulation—the FDIC and its charter regulator. But under the National Insurance Act, the entities made responsible for guaranties to policyholders of National Insurers—*i.e.*, the State guaranty funds in "qualified States"—would be prohibited from exercising any oversight equivalent to FDIC over these National Insurers. This would be equivalent to asking the FDIC to extend deposit insurance to State chartered banks while prohibiting the FDIC from supervising those banks or setting risk-based premiums for that protection. In 130 years of State-based insurance regulation, the industry has never suffered anything like the S&L crisis of the 1980s or the rash of bank failures in the late 1980s and early 1990s. How long the State guaranty fund system will be able to survive the examination-blind participation of National Insurers (which will also have less rate and market conduct supervision than under current state law) is an open question. This separation of solvency regulation and the guaranty function creates a troubling gap in the regulatory scheme. The States are clearly left holding the bag under this proposal, which could lead to dysfunction in the insurance marketplace to the detriment of both consumers and companies.

The banking system also does not have a distribution system equivalent to insurance agents and brokers, so there is no analogy in the banking context for what happens when dual charters are imposed on this distribution system. Because of this, IIABA believes that the NIA puts local independent insurance agents and brokers at risk of being Federalized. The NIA tries to diminish the problem by allowing producers to remain State-licensed and still be able to access both State and National Insurers for their clients. However, nothing in the Act explicitly prohibits the Commissioner of National Insurance, in his broad rulemaking authority, from conditioning either insurer or producer rules in ways that could effectively force producers to obtain an additional Federal license or even give up the State licenses. Additionally, the bill would allow Federal intervention in the form of market conduct reviews and audits even on companies and agents that choose to remain State licensed and regulated. All of this could lead to either dual regulation, or Federalization, of insurance agents throughout the country.

As mentioned earlier, the IIABA also believes that local insurance regulation works better for consumers and the State-based system ensures a level of responsiveness to both consumers and the agents who represent them that could not be matched at the Federal level. The NIA attempts to address this concern by providing for the establishment of Federal regional offices. However, to match the local responsiveness of State regulators a Federal office would have to be established in every state, and in many cases, multiple offices within each State. This would create an entirely new and completely redundant Federal regulatory layer. Why duplicate the current State-based system when you can build off its strengths and modernize it? There is no way out of this predicament for the supporters of OFC—either you significantly increase the size of the Federal Government to match state regulators' responsiveness to consumers or rely upon a distant Federal regulator in Washington, DC, to meet consumer needs—and they will fail to meet those needs.

By eliminating or drastically limiting regulatory review of policy language for the small commercial and personal lines property-casualty markets the NIA would leave consumers unprotected. IIABA has consistently supported the insurers' desire for greater pricing flexibility as we believe rating freedom will benefit consumers in the long run. However, we do not believe that complete freedom from supervision of policy forms is appropriate. Form supervision ensures that consumers receive the information necessary to understand the value of their policies and the terms of their insurance coverage. Nevertheless, the NIA, in a single 12 line section of the 290-page bill (section 1214), would effectively eliminate supervision of policy form content in the property-casualty sector, including personal lines and small commercial lines. The NIA would potentially foreclose access to transparent information necessary to place consumers in the position to compare property-casualty products and for regulators to ensure that products are fairly constructed, responsive to the public's needs, and otherwise in the public interest. The IIABA supports reasonable form review modernization such as consistent, limited time periods for State regulators to review forms, uniform product standards where appropriate, and less regulatory review for large commercial entities; but the NIA goes way too far.

The NIA could also potentially leave hard to insure risks with state insurers and cause a negative impact on State residual market mechanisms and other State funds which ensure that high-risk individuals and businesses obtain the insurance coverage they need. This could create an unlevel playing field for State and federally regulated insurers. Here's how: the NIA, in its broad preemption of all State laws that would otherwise apply to National Insurers, makes a limited exception for the

various State laws creating assigned risk plans, mandatory joint underwriting associations and other mandatory residual market mechanisms. However, the NIA fails to make a straight-forward requirement that National Insurers must participate and take their share of the burden for these mechanisms. This language only ambiguously provides that National Insurers (and National Agencies and federally licensed producers) shall "be subject to . . . applicable State law relating to participation" in such mechanisms.[2] Even this limited application is further qualified in the NIA by three more "outs" for National Insurers: (1) if the mechanism's rates fail to cover the "expected value of all future costs" of policies; (2) requires the National Insurers to use any particular rate, rating element, price or form;" or (3) is "inconsistent with any provision of the Act." These exemptions are not available to State licensed insurers and as a practical matter may well mean National Insurers do not participate. At the very least it will take years to resolve what that question-begging "laws relating to participation" really means. Nor is it clear who will decide that; other parts of the NIA suggest that the new Office of National Insurance not the States may assert prerogative to decide how these State laws apply. In the end, it is not clear that States will have any "club" or a "stick" to compel participation by National Insurers, given all of the other limitations and preemptions on State powers in the bill.

In short, as constructed in the NIA, a dual ("optional") system could likely de-populate the capital base which shoulders the voluntary and involuntary pools and residual market mechanisms for difficult-to-place risks. This could create adverse selection where these risks are only covered by State mechanisms and those insurers remaining at the State level, disadvantaging those State-charted insurers.

In the end, the IIABA feels that the NIA would lead to a needless Federal bureaucracy and unnecessarily infringe on States' rights. At a minimum, the States will be forced to provide a safety net for national insurers through the Federal mandate allowing entry of these insurers into State guaranty funds while being completely preempted from monitoring those companies for solvency. Worse, most of the States' tools for dealing with residual markets and market conduct problems will be preempted in some way for national insurers. National chartered insurers will have an unequal advantage by escaping State residual market burdens, as explained above, and may also enjoy an implicit Federal guarantee, no matter that they will also get equal coverage from the State guaranty funds. Moreover, unlike the Gramm-Leach-Bliley Act (GLBA) which effectively empowers the States through uniform regulatory standards, the NIA fails to give the any assistance except through the threat of regulatory competition. Thankfully there is another way to reform insurance regulation to the benefit of consumers, agents & brokers, and insurance companies: targeted Federal legislation already proven successful in GLBA.

National Association of Registered Agents and Brokers (NARAB)

One of the most significant accomplishments of GLBA for the insurance marketplace was the NARAB Subtitle dealing with producer licensing reform. Prior to the enactment of GLBA, each State managed its agent/broker licensing process in a distinct and independent manner, and there was virtually no consistency or reciprocity among the States. For agents and brokers, who increasingly operate in multiple jurisdictions, the financial and paperwork burdens associated with multi-State licensing compliance became overwhelming; and consumers suffered as duplicative and redundant regulatory requirements made it difficult for producers to be responsive to their needs. While problems still remain, producer licensing has improved measurably since GLBA, and these changes are a direct result of Congress' decision to address these issues legislatively.

NARAB put the ball in the States' court by threatening the creation of a new national, NASD-style licensing entity—known as the National Association of Registered Agents and Brokers—if the States did not satisfy the licensing reform objectives articulated by Congress. The creation of NARAB was only averted when a majority of the States and territories (interpreted to be 29 jurisdictions) achieved a specified level of licensing reciprocity within a 3-year period.

The NARAB concept shows what the Federal Government and the States can accomplish in partnership and how Congress can establish Federal goals or standards to achieve much needed marketplace reforms. The NAIC and State policymakers

[2] This formulation, which seems to defer the question of whether the National Insurer will actually be required to participate, is crucial because, for example, the "applicable State law relating to participation" would have been enacted before National Insurers existed and on its face may give National Insurers arguments that they are not caught in the net of such laws. It would have been more reassuring to policyholders and agents if the Act had mandated their participation as if they were State-licensed insurers in the same lines of business.

had been trying to move toward reciprocal and uniform licensing for over a century, but little progress was made until Congress acted legislatively. This first step to modernized licensing requirements would not have occurred without targeted Federal legislation, or what some are now calling "Federal tools."

IIABA's Support for Targeted Federal Reforms

IIABA supports State regulation of insurance but feels that the system needs to be modernized to bring it into the 2151 century. Despite our continued support for the State system, we question whether the States will be able to resolve their problems on their own. For the most part, State reforms must be made by statute, and State lawmakers inevitably face practical and political hurdles and collective action challenges in their pursuit of improvements on a national basis.

Therefore, IIABA believes that Congressional legislative action is necessary to help reform the State regulatory system. We propose that two overarching principles should guide any such efforts in this regard. First, Congress should attempt to fix only those components of the State system that are broken. Second, no actions should be taken that in any way jeopardize the protection of the insurance consumer, which is the fundamental objective of insurance regulation and of paramount importance to the IIABA as our members represent consumers in the insurance marketplace.

IIABA believes the best alternative for addressing the current deficiencies in the State based regulatory system is a pragmatic, middle-ground approach that utilizes Federal legislative tools to foster a more uniform system and to streamline the regulatory oversight process at the State level. By using targeted and limited Federal legislation to overcome the structural impediments to reform at the State level, we can improve rather than replace the current State based system and in the process promote a more efficient and effective regulatory framework. Rather than employ a one-size-fits-all regulatory approach, a variety of legislative tools could be employed on an issue-by-issue basis to take into account the realities of today's increasingly global marketplace. There are only a handful of regulatory areas where uniformity and consistency are imperative, and Congress has the ability to address each of these core issues on a national basis. This can be done in a single legislative act or through enactment of a number of bills dealing with a particular aspect of insurance regulation starting with those areas in most need of reform where bipartisan consensus can be established.

Congress's work in this area need not jeopardize or undermine the knowledge, skills, and experience that State regulators have developed over decades. While IIABA believes such a proposal must modernize those areas where existing requirements or procedures are outdated, it is important to ensure that this is done without displacing the components of the current system that work well. In this way, we can assure that insurance regulation will continue to be grounded on the proven expertise of State regulators at the local level.

Some optional Federal charter proponents argue that using targeted Federal legislation to improve State regulation is more intrusive on the State system than Federal regulation. We strongly disagree. The proponents would have you believe that the optional Federal charter proposals create a parallel universe of Federal chartered insurers but leave in place the State chartered system in pristine condition. This is not the case. In fact, to take one example discussed earlier, OFC would, as a practical matter, force the State guaranty funds to accept and backstop Federal chartered insurers—there is nothing "optional" about that. This would be an unprecedented intrusion on State solvency regulation—the State system would be responsible for insolvent insurers but could not regulate them to keep them from going insolvent. In contrast, targeted Federal legislation addresses limited aspects of State insurance regulation only where uniformity is truly necessary and is the least intrusive option. Unlike "optional" Federal charter, this approach does not threaten to remove a substantial portion of the insurance industry from State supervision almost completely pre-empting all application of State law.

Additionally, some OFC supporters have criticized the Federal tools approach because of enforcement concerns. They argue that Federal standards are only as good as the enforcement mechanism ensuring that States adhere to those standards. The reality, however, is that court enforcement of Federal preemption occurs regularly and would occur under both the Federal tools approach and the optional Federal charter. As long as the Federal standards are properly crafted and clear, enforcement of Federal standards would not create more burdens for the court system than litigation arising under the NIA. The only difference is that, under the NIA, a Federal regulator would receive deference to preempt State consumer protection laws and industry supporters would receive an advantage in court.

Ironically, those same groups who have criticized the targeted approach on both these grounds have recently embraced this approach in legislation introduced in the House just last month: H.R. 5637, the Nonadmitted Insurance and Reinsurance Reform Act of 2006. H.R. 5637 would create a uniform system of premium tax allocation and collection for surplus lines; provide for regulatory deference to the policyholder's home state for the nonadmitted/surplus market; adopt the NAIC nonadmitted insurance model act on a national basis; create streamlined access to the surplus market for sophisticated commercial purchasers; and rely on the home State for reinsurance solvency oversight while prohibiting extra-territorial application of State law. The legislation has near-unanimous industry support and significant bipartisan cosponsorship: nine Republicans and nine Democrats.

Conclusion

IIABA has long been a supporter of reforming the insurance marketplace. IIABA worked closely with this Committee in support of GLBA and 5 years ago IIABA's National Board of State Directors took a formal policy position to support Federal legislation to modernize State insurance regulation. While GLBA reaffIrmed State functional regulation of insurance, some large insurers are now advocating for an "optional" Federal charter. State regulators and legislators, many consumer groups, independent insurance agents and brokers, some life insurance companies, and many property-casualty companies are strongly opposed to an optional Federal charter. The State system has proven that it best protects consumers and can be modernized to work effectively and effIciently for the entire insurance marketplace with the right legislative pressure from Congress.

Targeted, Federal legislation to improve the State-based system presents Members with a pragmatic, middle-ground solution that is achievable—something we can all work on together. Unlike the creation of an entirely new regulatory structure, the enactment of targeted Federal legislation to address certain, clearly identified problems with State regulation is not a radical concept. The Senate Banking Committee has already proven that this approach can work with the NARAB provisions of GLBA. Congress can achieve tangible reform for insurance consumers now while the debate concerning broader more radical reforms continues. We encourage the Senate Banking Committee to take up this targeted approach once again—it is the only solution that can bring the marketplace together to achieve reform.

PREPARED STATEMENT OF JOSEPH J. BENEDUCCI

PRESIDENT AND COO, FIREMAN'S FUND INSURANCE COMPANY

JULY 11, 2006

Good morning, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. My name is Joe Beneducci, and I am President and Chief Operating Officer of Fireman's Fund Insurance Company (Fireman's Fund). Fireman's Fund Insurance Company is a premier property and casualty insurance company providing personal, commercial and specialty insurance products nationwide. Fireman's Fund is a member of the Allianz Group, one of the world's largest providers of insurance and other financial services. Founded in 1863 with a mission to support firefighters, Fireman's Fund proudly continues this mission today through the Fireman's Fund Heritage program.

Through the Fireman's Fund Heritage program, Fireman's Fund employees and its network of independent agents award grants and provide volunteer support to local fire departments, national firefighter organizations and non-profit fire and burn prevention organizations. Since launching the program in 2004, the company has awarded millions of dollars each year toward the purchase of equipment, firefighter training and community education programs.

I appreciate the opportunity to be here today on behalf of Fireman's Fund and our property-casualty insurance trade group, the American Insurance Association (AIA), and its more than 400 members, to discuss insurance regulation reform—a topic that is critically important to Fireman's Fund and AIA, to the individuals and businesses that we serve, and to the industry that we represent.

We applaud this committee's leadership in recognizing the need to examine the insurance regulatory system. Reform is critical to enhancing competition, fostering innovation, and providing a solid foundation for underwriting the risks necessary to advance a strong U.S. economy—all to the benefit of policyholders and the public at large.

Today, we stand at a regulatory crossroads that may well determine the future of the insurance marketplace in the 21st century, its ability to respond effectively and efficiently to losses—catastrophic or otherwise—and the appropriate role of gov-

ernment. With this context in mind, I would like to start with three observations about the property-casualty insurance market and the best way to regulate the market:

1. Our economy is not static and continues to become more global every day. Consumer needs continue to expand and grow in conjunction with our economy. These evolutions have surpassed the current insurance regulatory environment's effectiveness and viability.
2. The current regulatory system inhibits innovation and actually perpetuates commoditization.
3. A market-based optional Federal charter can benefit consumers by reforming regulation and encouraging innovation, while retaining the state regulatory system for companies that wish to remain there.

Let me elaborate on these observations. There is little disagreement that the current system is broken. Many proposals have attempted to deal with the inadequacies of that system. Indeed, insurance regulatory reform has been a topic of discussion for more than a century. The National Association of Insurance Commissioners (NAIC), the state regulators' trade association, first pledged to reform the state insurance regulatory system and to achieve uniformity during the Grant Administration in 1871. More recently, since enactment of the Gramm-Leach-Bliley Act, the state regulators have renewed that pledge, and have worked through the NAIC, other organizations, and within their respective states, on a variety of state-based models, laws, and regulations aimed at modernizing the regulatory structure. Although they were and are sincere in their efforts, no one has come close to delivering a modern system that empowers consumers and focuses on real consumer protections. As a result, we remain within a regulatory framework that, by its very nature, lacks uniformity and does not allow insurers to keep pace with ever-changing insurance consumer needs.

It is time for a new approach. We believe that an optional Federal charter approach, which relies on a combination of free markets and a tightly focused regulatory system, represents our best opportunity to advance regulatory modernization that works for consumers, the industry, and the economy.

Three basic principles undergird an optional Federal charter approach:

- Place primacy on the private market, not regulatory fiat, creating an environment that empowers consumers as marketplace actors;
- Focus government regulation on those areas where government oversight protects consumers in the marketplace, such as financial integrity and market conduct, rather than on those activities that distort the market, such as government price controls and hostility to innovation; and
- Establish uniform, consistent, and efficient regulation.

We believe it is very important for the committee to judge any reform proposal against these principles to ensure that any legislation that may be enacted does not create or add more unnecessary regulatory burdens, does not inadvertently restrict the options that a vibrant private market can offer to consumers, and adds to the efficiency and strength of insurance regulation.

We strongly support the bi-partisan National Insurance Act of 2006 (S. 2509 or Act), introduced by Senators Sununu and Johnson April 5th, and believe that the reforms contained in the Act reflect these principles. The legislation provides insurers the option of being nationally regulated, while at the same time preserving the current state regulatory system for insurers that believe they can better serve their policyholders within that framework. Importantly, it also would preserve critical elements of the current state system, such as state premium taxes, the state guaranty fund system, and certain local prerogatives with respect to workers' compensation and motor vehicle insurance coverage requirements.

The regulatory system articulated in S. 2509 is modeled after the dual banking system—a system that has worked well for almost 150 years. For insurers, passage of S. 2509 would be an important next step in this committee's work on financial services modernization, building on the Gramm-Leach-Bliley Act.

Most fundamentally for property-casualty insurers that choose a national charter, S. 2509 would "normalize" regulation and allow the marketplace—and, by extension, consumers in that marketplace—to dictate the full range of price and product choices, rather than empowering the government to do so through price and product controls. In implementing a market-driven approach to the regulation of insurance prices, S. 2509 would subject insurer pricing activities to the Federal antitrust laws to the extent those activities are not regulated by state law.

Although opponents may try to characterize elimination of government rate and policy form review as "deregulation," it is not. By de-emphasizing those aspects of regulation that tend to politicize insurance and weaken the private market, S. 2509 establishes stronger, re-focused regulation in those areas where regulation actually is necessary to protect consumers as they navigate the marketplace and when they turn to financially sound insurers for payment of covered claims. Under this modernized system, the Federal Government will not be a market participant, nor will it exercise business judgment. Above all, enactment of S. 2509 will assure that the insurance safety net remains strong despite the ever-changing nature of risk.

The Critical Need for Insurance Regulatory Reform

The current state insurance regulatory system grew out of the McCarran-Ferguson Act, which was enacted in 1945 largely to deal with Federal antitrust and state tax concerns arising from a 1944 U.S. Supreme Court determination that insurance was a product in interstate commerce and, therefore, subject to Federal authority.

McCarran is a power-sharing statute that reflects Congress' considered judgment to delegate—not abdicate—its authority over insurance to states that regulate the business of insurance themselves. In doing so, McCarran recognizes that Congress has the right to intervene in insurance regulatory matters by enacting specific Federal laws and provides insurers with an antitrust regime that is based on the insurance regulatory role being entrusted to the states. Within this statutory structure, it narrowly protects insurers from application of the Federal antitrust laws to the extent that the business of insurance is regulated by the states.

Under McCarran, the states have put in place sweeping regulatory regimes that dictate what products insurers can provide, how much they can charge for these products, and how they conduct even the most routine aspects of their business. The result has been a regulatory scheme that: 1) is focused on government intrusion in the market, particularly in the area of insurance rate and form oversight; and, 2) reflects assumptions about the insurance industry, insurance companies, and insurance consumers that, while perhaps true in 1945, are far from accurate today.

In this connection, the current system relies on outdated, discredited government price and product controls, which are rationalized by regulators in the name of "protecting consumers," but which, in truth, serve merely to interfere with the proper functioning of the private market—to the detriment of consumers. These controls are imposed in virtually every state, often in different and inconsistent ways. Even within each jurisdiction, there are often differing systems for different lines of business, making the process incredibly inefficient and ultimately unresponsive to consumer needs. A limited survey by AIA of state rate and form requirements found hundreds that dictate how rates are to be filed and reviewed, and that relate to the filing and review of new products. This cumbersome apparatus simply is not viable in a society that relies on instant availability to consumers of most other products and services. Indeed, the property-casualty insurance industry remains the only U.S. financial services industry that still labors under a pervasive system of government price and product controls.

A Better Regulatory Alternative

Systemic insurance regulatory reform is urgently needed for the good of insurance consumers and for the health of the insurance marketplace. We need a new regulatory alternative based not on regulatory red tape and government decisions concerning the "appropriate" rate for an insurer to charge or the "appropriate" insurance policy to offer to consumers, but on a rational reallocation of regulatory resources to focus on the most critical aspects of the insurance safety net. Additionally, the new system must replace the current patchwork of conflicting state requirements with national uniformity for insurers operating at the multi-State or national level. S. 2509 embodies all of the elements of this paradigm and represents the best approach for Congress to move forward in advancing reform.

I would like to discuss some of these concepts in more detail.

Free Market Principles Allow Competition To Flourish

The entrenched state focus on government price and product controls discourages innovation and competition, ultimately denying consumer choice. The current regulatory system concentrates on the wrong principles. Ultimately, it is economically unwise for government to repress prices, since this masks market stresses and problems. Over a period of time, this can lead to a market crisis, forcing sizable subsidized residual markets and market withdrawals that exacerbate the problem. In this way, the use and administration of government price and product controls limits flexibility for both insurers and consumers. It also leads to a stark choice for companies as to whether to continue writing insurance at all, rather than providing

the market freedom and range of options necessary for insurers to write as much coverage as possible.

Recent attempts at reforming state rate and policy form regulation have focused on changing the type of review (*e.g.,* from "prior approval" to "file and use"), implementing so-called "flex rating" bands (which allow insurers to depart upwards or downwards from filed rates by a certain percentage—typically from 5 percent to 12 percent—without regulatory approval), and adopting exemptions for commercial policyholders that meet identified threshold criteria. While these measures may have been designed to provide modest improvement, they do not address the fundamental problem with the state regulatory approach.

First, altering the type of review required does not change the fact that pre-market intervention should not be occurring in the first place. It also does not address the concern that even the most liberal rate and form review system can be administered in a way that is just as onerous as the most restrictive system.

Second, the creation of rating flex bands simply imposes government restrictions on private markets, and, contrary to their name, limit the flexibility of consumers and insurers outside the band.

Third, based on experience with so-called "exempt commercial policyholder" laws in the various states, setting threshold criteria that will allow certain policyholders to qualify for the exemption results in a "winners and losers" contest that is antithetical to the concept of market-based pricing. All policyholders, regardless of size or sophistication or line of insurance, should be entitled to purchase insurance from insurers operating in a free market environment.

Forcing private businesses to submit their products and prices to a government official for review and approval is anathema to the free market environment that forms the backbone of the U.S. economy. Price and product controls are historical artifacts that have turned insurance prices and products into political pawns that are used to artificially suppress the real cost of risk and to delay products from being offered to consumers, or, worse, to keep product options from consumers altogether. This is a dangerous form of government intervention in private markets—one that is at odds with our free market economy—which distorts the real costs of assuming risk and discourages prudent risk management behavior by individuals and businesses. Consumer empowerment in the marketplace should not be replaced by needless regulatory control.

Uniformity Is Critical in Serving the Needs of a National and International Economy

The current regulatory system is a jumble of individual state statutory and administrative requirements. As previously noted, state insurance codes have spawned hundreds of different rate and form regulatory requirements for the various lines of insurance, along with many more disparate market conduct, claims, and other requirements. Companies wishing to launch a national product cannot do so until both the price and product have been separately reviewed or approved in every state; this can take years to accomplish. Moreover, the need for insurers to meet differing regulatory demands in each jurisdiction increases compliance costs, discourages innovation, and makes it difficult for insurers to service customers doing business in more than one state.

Insurance Regulation Should Focus on Solvency and Protection of the Insurance Safety Net

Certainty and security are critically important principles for insurance consumers. A regulatory system ought to focus on ensuring that a company is solvent and able to pay claims to instill confidence among insurance consumers. The property-casualty insurance industry stands out as one of the most heavily regulated sectors of the U.S. economy. However, this is not just a question of regulatory degree, but additionally, of misguided regulation that rewards inefficient market behavior, subsidizes high risks, and masks underlying problems that lead to rising insurance costs. Resources are misdirected to "front-end" price and product regulation, while core functions like financial solvency have taken a back seat. This is both unfortunate and dangerous, because less focus on solvency means less security and less confidence by consumers that covered claims will be paid. Financially sound insurers are in everyone's best interest, because they are the heart of a healthy, vibrant market.

The Market-Based Optional Federal Charter Approach in S. 2509

We believe that a market-based optional Federal charter approach provides the best route to insurance regulatory reform. This is a regulatory system that has worked well in the banking industry for well over a century, and will modernize the insurance industry if adopted. It does not regulate prices charged and products offered by market participants, because it recognizes that governments, acting unilat-

erally in these areas, cannot be effective surrogates for the free market. Rather, it places regulatory emphasis on ensuring that companies are financially sound and that consumers are protected from misconduct by market participants. These are core regulatory functions for most industries, and insurance is no exception. In addition, the optional Federal charter would bring needed uniformity for those choosing a national license, while respecting the decisions of others to remain under state regulatory authority. Fireman's Fund and AIA support the re-direction of regulation that an optional Federal charter promises, and look forward to both defending and advocating this regulatory framework for property-casualty insurers.

The structure of S. 2509 creates this modernized regulatory paradigm. Insurers opting for a national charter are regulated by the Office of National Insurance, housed in the Department of Treasury, led by a National Insurance Commissioner appointed by the President with the advice and consent of the Senate.

The Act requires creation of six regional offices, with discretion given to the Federal regulator to authorize as many additional local offices as necessary. Those opting in to the Federal system directly fund Federal regulation, in addition to continuing to pay state premium taxes. The Office of National Insurance is the single focal point of regulation for nationally chartered insurers, and that office applies the standards set forth in the Act or promulgated by regulation, addresses complaints concerning nationally chartered entities, and enforces the requirements of the Act. Thus, the Act supplies the framework for uniformity, consistency, and clarity of regulation that the state system has failed to create.

The Act also effectuates a fundamental shift in regulatory application. Under this approach, the regulatory system for national insurers starts from the premise that governments should not stifle the growth of private markets through rate suppression, product denial, or other intervention, but should allow private markets to flourish, with insurers and consumers agreeing on the sharing of risk of loss.

In exchange for relief from rate regulation, the Act applies Federal antitrust laws to insurer pricing activities that are no longer regulated. AIA members, including Fireman's Fund, are willing to take the risks inherent in this approach on the antitrust side because we so strongly believe that a market without government rate and price controls is critical to being able to serve customers in the years ahead.

While S. 2509 relies on markets to determine the price of insurance and trades pricing freedom for application of the Federal antitrust laws, it does not abandon aspects of the state system that are necessary. In this respect, the Act recognizes that there always will be a need for markets of last resort—so-called "residual markets"—and that national insurers must participate in those markets when participation is mandated by state law. Consistent with free market principles, however, insurance prices in the subsidized residual market must be adequate to prevent "backdoor" competition with the private market. In addition, the Act requires national insurer participation in state-mandated statistical and advisory organizations, and workers' compensation administrative mechanisms—again, with the proviso that states cannot use mandatory participation to re-impose rate and form regulation over national insurers. This careful balancing of market-based pricing and participation by national insurers in the data collection mechanisms that support the state structure makes S. 2509 an ideal model for rate regulatory modernization.

As previously noted, the Act also provides for relief from government product controls, particularly from the required use of any particular policy form, but it includes Federal supervision of policies used by national insurers in the marketplace. First, the Act requires national property-casualty insurers to submit annually a list of all standard policy forms they use to the Office of National Insurance. Second, under the Act, national insurers must maintain copies of all of the policy forms they use for inspection by the Federal regulator. The combination of these two requirements ensures that Federal regulators will be aware of the policy forms that are being offered in the market, but that they will not be able to interpose Byzantine review and approval standards. These standards in many states have led to delays of months—and sometimes years—in the roll-out of insurance policy forms intended to be used nationwide.

The Act also includes special provisions that require national insurers to adhere to compulsory coverage standards for motor vehicle and workers' compensation insurance. Even here, though, states may not use these special provisions to re-impose rate regulation on national insurers.

We believe that the market-driven approach for insurance rates and policy forms outlined in S. 2509 is key to cultivating and maintaining a healthy insurance environment that works for both business and individual insurance consumers. Indeed, market regulation of insurance rates and policy forms empowers consumers, because consumer demands will drive the range of product and pricing options available to them. This stands in sharp contrast to the current regulatory approach, which em-

powers regulators and often makes them the principal market participant. This, in turn, leads to property-casualty insurance commoditization, as regulators are not well-positioned to understand the evolving insurance needs of individuals and businesses. For these reasons, we support the approach taken by S. 2509, which demonstrates faith in consumers in the marketplace.

Just as S. 2509 allows private markets to thrive through elimination of government price and product controls, it regulates all other aspects of the business of insurance. First, the Act provides broad authority to the Federal regulator to protect consumers against misconduct by nationally chartered entities in the market. The Act's market conduct provisions cover all aspects of insurance operations, and contemplate rulemaking to provide the more detailed parameters of that authority.

Second, the Act provides strong Federal oversight of national insurers' financial condition in order to ensure that companies are financially sound and able to pay covered claims. It also includes accounting, auditing, actuarial, investment, and risk-based capital standards. For financial solvency, the Act defers to the state guaranty fund system, requiring national insurer participation in that system, but at the same establishing "qualification" standards that the state guaranty funds must meet to avoid triggering the national insurance guaranty corporation established by the Act. In these areas, the Act generally follows uniform standards established by NAIC models.

For insurance consumers, the Act establishes both a Federal ombudsman to serve as a liaison between the Federal regulator and those affected by the regulator's actions, as well as consumer affairs and insurance fraud divisions to provide strong consumer service and protection.

Over the long-term, it is our view that a Federal regulatory option, structured in the way set forth in S. 2509, will modernize regulation of the industry, empowering consumers and emphasizing market conduct and financial solvency oversight in the process. In creating these needed systemic reforms, the Act will consolidate regulation into a single uniform point of enforcement for those that choose the Federal charter, without forcing change for those choosing to stay in the state system.

The Critical Need To Move Forward

Insurance regulatory reform is not an academic exercise; it is a critical imperative that will determine the long-term viability of one of our nation's most vital economic sectors, and help define how our economy manages risk in the future. The choice is between the existing state regulatory bureaucracy or a new approach that relies on the hallmarks of the free market and individual choice and recognizes the evolution of our customers' needs in our global economy and insurers' ability to support those needs in a modernized regulatory environment.

Without a doubt, everyone here supports a healthy U.S. insurance marketplace that serves and empowers American consumers. We appreciate that creation of such a modern, dynamic market is not without challenges, and that change can be unsettling for some. However, we believe that creating an optional Federal charter is imperative to meet the needs of all types of customers and insurers. There is no compelling reason not to fully explore and debate this proposal.

Fireman's Fund and AIA look forward to defending and advocating an optional Federal charter that truly would serve consumers by fostering efficiency and innovation. We strongly support S. 2509 and thank Senators Sununu and Johnson for putting forth this thoughtful legislation.

PREPARED STATEMENT OF JAXON WHITE

CHAIRMAN, PRESIDENT, AND CEO, MEDMARC INSURANCE GROUP

JULY 11, 2006

Chairman Shelby, and other Members of the Committee, I am Jaxon White, Chairman, President, and Chief Executive Officer of the Medmarc Insurance Group. I am a member of the Board of Governors of the Property Casualty Insurers Association of America ("PCI") and I am here today to present the association's views regarding regulation and competition in the insurance industry. I appreciate the opportunity to appear before the committee.

PCI has been a supporter of the state regulatory system. We remain hopeful that the current system can be reformed to address the many problems our members encounter. However, since the current Federal discussion and consideration of insurance regulatory reform began in 2002, we have not seen substantive, meaningful reform in state regulation. We still would like to see such change and stand ready to work with the states to accomplish reform. It just has not happened.

PCI Reflects the Views of the Broad Industry

The mission of PCI is to foster a healthy, well regulated, and competitive insurance marketplace that provides both personal and commercial insurance consumers the opportunity to select the best possible products at the best possible prices from a variety of competitors. PCI provides a responsible and effective voice on public policy questions affecting property/casualty insurers and the millions of consumers we serve.

PCI is uniquely positioned to speak to issues concerning insurance regulation. PCI members write nearly 40 percent of all the property/casualty insurance written in the United States, including 49.5 percent of the nation's auto insurance, 38.3 percent of the homeowners policies, 31.5 percent of the business insurance policies, and 40.2 percent of the private workers' compensation market.

The insurance industry is very complex, given the myriad of products and the ways in which insurance products reach the consumer. PCI reflects that variety in its membership and, as such, is well suited to say if a given proposal addresses the full complexity and needs of the industry.

PCI members are stock, mutual, reciprocal and lloyd's in form. Our members write on an admitted and surplus lines basis and as risk retention groups. Products are distributed through: agents, captive, employees, independent agents, brokers, surplus lines brokers, managing general agents, and directly to the consumer via telephone, Internet, and company direct mail. Our members are national, regional, single state in their company scope, and range in size from the very small to some of the largest and most well-known insurers in the country. We represent multi-line writers, personal lines-only writers, commercial lines-only writers, specialty writers and monoline writers. PCI members write all lines of business in every State.

For the last 21 years, I have served as chief executive officer of the Medmarc Insurance Group. Our core products are products liability and general liability, targeted primarily to manufacturers and distributors of medical devices and life science products. Interestingly, I serve an industry that is itself federally regulated. We also write lawyers' professional liability in 24 states and the District of Columbia.

While my personal experience and that of Medmarc is not as broad-based as that of PCI, our experience crosses a number of disciplines in the insurance world. Our group consists of three property casualty writers and an insurance agency. The parent company is mutual in form. Its three subsidiaries are all stock companies, domiciled in different states.

Many would consider Medmarc to be a small organization, but not insignificant in size. Our 2005 direct premiums were over $100 million, with $66 million in net premium. We write on both an admitted and a surplus lines basis in all states and the District of Columbia. We are subject to myriad filing and reporting requirements for our admitted companies in 51 jurisdictions to maintain our ability to do business and to bring our products to market. Financial reporting to regulators is done on a quarterly and annual basis and statistical, actuarial and other reports are filed routinely throughout the year. This translates into hundreds of filings made for each company, every year. There are also reporting requirements for our surplus lines company and, contrary to what some might say, surplus lines is not free from regulation.

Consumers

Insurance regulation affects more than just the insurers who operate under these rules. Consumers are directly affected by the regulatory environment, since it controls the products they receive, the financial solidity of their insurer, and, in many cases, the price they pay. Overzealous or unnecessary regulation harms consumers when it restricts competition and limits consumer choice. Others with a stake in the system include lenders desiring a degree of protection for assets, investors, and the community as a whole. Most important, the regulatory environment can have a significant impact on the states' and the nation's economy, since the financial protection afforded by insurance minimizes and manages risk and encourages businesses to expand and create new jobs.

PCI Members Support Competitive Markets for Consumers and a Regulatory Focus on Solvency Protection

Despite the diversity of PCI's membership, all our members share the common vision that consumers are best served when markets are free, fair, competitive, and fairly regulated. Consumers in those states where regulation fosters a healthy competitive environment have the greatest number of product choices and the most competitors offering those choices. They benefit as well by having a system that allows products to respond swiftly to changes in their needs. PCI also believes market-oriented regulation frees up regulators and regulatory resources to focus on the

most important regulatory function: ensuring that the real promise of insurance—that the insurer will be there to pay a claim—is always met. In other words, to focus on strong, sound solvency regulation.

The Regulatory System Imposes Needless Opportunity Cost and Limits Consumer Choice

One of the inherent problems with the current system is the continued inconsistency of the regulatory environment from State-to-State. State regulation remains a patchwork quilt of inconsistent rules and regulations, making it difficult for companies to operate in some markets, increasing the cost of regulatory compliance, and reducing the amount of choice, both in terms of companies and products, that consumers have.

To the extent consumers cannot obtain products they need, they bear an important opportunity cost as needs for financial protection remain unmet or are addressed in less efficient ways.

Insurers, too, bear an important opportunity cost when unnecessary regulation prevents a product from being brought to market quickly and efficiently. Regulation reform that eliminates such obstacles avoids such important opportunity costs and benefits consumers. Capital is limited and companies in any industry will consider entering markets that provide them the best opportunity to earn a fair return on investment. The regulatory environment has a significant impact on these business decisions and in the last 4 years, we regret to say that we have not seen that environment get significantly better.

The concept of opportunity cost is clear when comparing the situation where similar products are offered by the banking industry and insurance industry. The concept of speed to market rests on the idea that banks are able to quickly offer products that are responsive to an expressed market need, usually without prior product approval by a regulator. A competing insurer, offering a similar and competitive product, is at a disadvantage in having to wait for state approvals in order to introduce the insurer's new, similar product. The same situation exists even without comparison to the banking industry when an insurer is prevented from gaining approval of product improvements, modifications or new product offerings in an efficient and timely manner. Market opportunities do not last forever and the regulatory approval process can and does significantly stifle the introduction of new products and services. Consumers pay these costs in the form of reduced competition, higher prices and fewer products from which to choose.

Consumers Ultimately Bear Unnecessary Costs

Consumers are also hurt by the fact that they inevitably bear the burden of the systemic costs of needless regulation. As is true in any market economy, the costs of producing a product or service are borne by the consumer, including the cost of regulation. In our view, consumers should only bear the cost of necessary regulation, not needless regulation. Much of the regulatory structure today is needless, given the highly competitive nature of our industry. Over the past 4 years, we have certainly seen efforts by the states at making incremental improvements in the system, but these have been more of form than of substance.

As Congress considers the insurance regulatory system and various proposals for reform, PCI recommends that any proposal be examined in light of the costs that would be passed on to the consumer. We urge you not to forget that some reform proposals may add significant costs of regulatory overlap or dual regulation onto consumers. Or a system might place an additional burden of regulation by the courts, adding a cost of litigation to the true cost of regulation. Or, as is currently the case, a proposal may impose costs arising from a lack of uniformity across the states or create regulatory diversions that make the regulatory system unable to focus on the most critical element of insurance regulation, solvency.

In summary, PCI believes that consumers want good, responsive products at a reasonable price offered by companies who pay claims when they are owed. Restrictive or obsolete regulations which erect barriers to entry, impose inappropriate costs, or limit product availability and innovation only burden the system and harm consumers. An effective regulatory system should result in greater choice, convenience and innovation for the consumer.

Competition Should Be the Cornerstone of Reform

The cornerstone of any regulatory modernization effort must be modernization of rate and form filing requirements. While we have seen some improvements in some states in the last few years, we do not believe these efforts have gone nearly far enough or resulted in nearly enough change on an aggregate basis.

This is an issue I've dealt with firsthand. My own company, as well as all other PCI members, finds the current system too complex, to expensive, and too uncer-

tain. We never know when we will be able to bring a new product "on-line"—or even if a state regulator will allow us to do so. This limits our ability to adapt to changing market conditions and restricts our ability to compete.

As we developed our company, we found that our normal profit planning became very difficult as did our ability to do business in a state. To us, rate and form requirements in the states where we wanted to do business were so bad that we made the business decision to purchase a surplus lines insurer, free of significant elements of rate and form regulation, rather than attempt to run the gauntlets of state approvals. This was a solution that worked for us, but the nature of the business for other insurers may leave them unable to adopt such a plan due to their unique circumstances.

What Has Happened in the Last 4 Years?

The most recent round of discussions regarding state regulatory reform began about 4 years ago. Since then, there have been numerous hearings, both in the House and Senate. PCI testified on March 31, 2004 before the House Financial Services Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee stating:

> Meaningful reforms that reflect the way business is conducted and are adaptable to the changing business environment must be adopted. Current regulatory systems frequently cause delays in new products offerings for consumers and impose needless, and costly, rate approval processes. In some states, the company and agent licensing processes are also lengthy and cumbersome. Conversely, in other states, the market withdrawal process is bureaucratic and punitive in nature. Financial and market conduct examinations are often disjointed and inefficient, and suffer from a lack of coordination. These areas of state regulation must be improved and simplified and greater uniformity must be achieved.

PCI members are disappointed by the poor track record of the states toward those meaningful reforms in the last 4 years. Some procedural progress has been seen, but even these procedural changes place new burdens on insurers in states that otherwise would not impose the burden, but for the desire for uniformity of procedure. Stated another way, we have seen some change in form, not always clearly for the better, and little change in substance.

Despite the efforts of a number of states to modify the rate and form filing requirements toward a more open market, on an aggregate basis, the regulatory landscape in the states remains virtually unchanged for the last 4 years.

There is no uniformity across state lines as states still differ significantly on how property/casualty rates and forms are regulated. Even within a state, different lines of business continue to be regulated differently. Insurers still must submit personal lines policy forms for review and approval in over 40 States before the forms can be used. For personal lines rates, insurers can submit rates on a file and use basis in approximately thirty states, while the remaining number of states are primarily prior approval. Implementation of "file and use" may sound like an improvement, but there are significant lead time requirements with file and use that an insurer must adhere to prior to releasing a product into the market. Also, many insurers feel it safer to treat "file and use" as *de facto* prior approval because of potential retroactive disapprovals and requirement that the insurer must disgorge any profits made during the period.

Approval remains the determining element in all filing methods, whether prior approval, file and use or use and file. The result is political manipulation ranging from outright disapproval to disapproval of rating plans, rating factors, discounts and territorial rating. Rates no longer reflect true risk of loss, but rather a system of subsidies, unjustly higher rates for some, and a stifling of competition. The consumer continues to lose.

There is less restrictive regulation on the commercial lines side, but given the multi-State nature and the commercial savvy of those insureds, much more streamlining is needed, but has not happened.

Most states allow commercial policy forms to be submitted under file and use rules. However, commercial insurers have the same concern with "file and use" regarding retroactive disapprovals. "Speed to market" does not really exist, as companies must wait to receive approvals before using their products. Many commercial risks operate in a multi-State environment with needless regulatory complexity for both the business consumer and the insurer. To meet the needs of multi-State commercial risks, insurers need to secure approval of a new or revised commercial policy form and the corresponding rates in the majority of the states before the product can be implemented for the multi-State insured.

It is true that some states have continued to pursue a bona fide regulatory modernization agenda, but those are few in number and limited in scope. For example, South Carolina enacted legislation as follows:

- In 1999, a flex rating system for auto was implemented.
- In 2000, South Carolina eliminated prior approval rate requirements for commercial policies with a threshold of $50,000 in premium or more. In 2002, the premium threshold was removed.
- In 2004, legislation was enacted implementing flex-rating for homeowners.

Other states have taken some steps toward improving the regulatory review process. For example, Maryland in 2000 implemented a rate filing exemption for the large commercial risk with a premium threshold of $75,000. In 2006, the premium threshold was reduced to $25,000. Other states have similarly implemented or expanded exemptions for large commercial risks. But not all states have exemptions for large commercial risks and thresholds for determining the exemption vary greatly by state. It still is difficult if not impossible for an insurer to place, with certainty of compliance, a multi-State exempt risk.

As to some particular states, we have seen positive auto reforms in New Jersey and some progress in flex rating in Connecticut, but flex rating is an incremental progress. However, in the Massachusetts auto insurance market, perhaps the nation's most restrictive regulatory environment, the only progress has been discussion and bill introduction to reform the auto market. It remains a state in which the number of auto insurers doing business is significantly lower than is typical in the states throughout the nation. At this point, we have to say that we hold slim hopes of passage of meaningful auto insurance reform in the near term.

The NAIC and the states joining the compact are to be commended for progress regarding the life insurance compact. However, progress on property & casualty rate and form filing requirements has been limited to the implementation of State Filing Review Requirements Checklists and the System for Electronic Rate and Form Filing (SERFF). But SERFF is procedural, not substantive, as to a company's ability to use a rate or a form. The majority of the states are accepting SERFF filings for property/casualty but not all lines in all states. Per the SERFF web site, only 302 filings were processed via SERFF in 1998. In 2005, 183,362 SERFF filings were processed. Even with SERFF, Florida has developed its own electronic filing system in order to meet its own internal processing needs.

SERFF is only an electronic delivery system for filings, addressing process, but it does not significantly assist with true speed to market as the actual approval process remains. The implementation of the checklists combined with the SERFF tool do nothing to address the underlying law or the cultural practices and desk drawer rules that some state insurance departments have institutionalized. These tools do not address the varying requirements among states nor do they address variances among state analysts in the same insurance department.

Promulgation of filing checklists is a procedural improvement. As of July 1, 2006, all states with the exception of five have developed and published state filing requirements checklists for property and casualty lines of business. That is all they are, however, checklists regarding filing.

In the area of company licensing, my company chose to buy an admitted carrier as we did not believe in 1995 that we could be licensed in all states within 5 years. I am not certain that my opinion would change today. The NAIC has made procedural progress with the Uniform Certificate of Authority Application (UCAA) to cut the red tape of applying for a certificate. However, in doing so, the UCAA, in order to accommodate each state's unique requirements, made the requirements additive of numerous differing state requirements, or the "highest common denominator" by including many individual state requirements so that the application contains many items that many states do not use or consider in the application process. This is not better regulation, only an amalgam of each state's requirements. On the substantive side, there were provisions encouraging states to respond by a certain date to applications. In practice that is not always followed so that an insurer cannot plan a date by which it can reasonably expect to be able to do business in a given state. Finally, some states continue their unique requirements. I'm not sure if this is reflective of better state regulation or not, but one PCI member indicated that, for their company to implement a multi-State corporate name change, it took 1 year. In and of itself, an improvement, but given that this is only a change of name, much too long a time to implement so simple a change.

It is necessary here to talk about "desk drawer" rules. These are regulatory rules that have not been codified or formally adopted through regulatory proceedings. Insurance companies are not in a position to know what the desk drawer standards

are in advance, and they are used by states with applications for a license, in rate or form filings or in market conduct examinations. Companies are not kept abreast of revisions, should they occur as these rules are unwritten. In fact, the authority for these standards is often lacking or questionable. Applications of these unpublished and unpredictable procedural requirements often serve as barriers to market entry and thwart the efforts of insurers to offer new products and services for consumers.

As to producer licensing, the NAIC and the states did move quickly toward reciprocity to avoid NARAB, but this was due to the pressure from the Gramm Leach Bliley Act. There has been some streamlining of procedures regarding licensing including a uniform application. However, as a practical example, procedures for handling something as simple as a producer's change of address have not yet come "on line." Nor has there been real movement toward uniformity of licensing.

In the area of market conduct, as a businessman, one thing I look for is certainty and predictability of outcomes. We can adapt to requirements, hopefully fair, that are set before us. But in the area of market conduct examinations, we have not seen a movement toward consistency and clarity. Desk drawer rules are often used to critique a company. Examinations are often neither targeted at insurers with evidence of market conduct problems, nor are they always coordinated to minimize expense to the company. One aspect of market conduct examination has actually gotten worse. PCI has seen a rise in the use of "contract examiners" who bring to the process an inherent conflict of interest in that it is in their interest to extend examinations upon the insurers for whose examination they will be paid, ironically, by the insurer.

Further Considerations

Even considering where the regulatory system stands today and of the lack of progress in reform over the past 4 years, PCI strongly urges Congress to move with caution in considering changes to insurance regulation. PCI supports the state regulatory system and we would like to see state system improved. Any reform proposals must take into account that insurance is a major part of the U.S. economy and a complex market that has evolved over time. We urge careful consideration of potential unintended consequences of changes before any actions are taken.

We believe the best place to start the debate is to define the principles of a good regulatory system, determine what such a system should accomplish, and then determine how best to correct the flaws in the current system. PCI is looking at various models of business regulation, here in the United States and abroad in an effort to build such a regulatory model. For example, one question is, should "principle based regulation" rather than "rules based regulation" be the standard for financial regulation and would the concept be exportable to insurance regulation in other areas or in general? We have also spoken about various areas of insurance company operations. As we examine the regulatory system, we will be looking at those areas to determine what might define "good regulation" of those activities. We urge Congress and anyone else looking at insurance regulation to do the same.

As you continue your review and consideration of these issues, we look forward to working with you and offering our perspectives on the proposals you will consider. PCI offers a reflection of the considered views of the breadth of the insurance industry.

PREPARED STATEMENT OF ALAN F. LIEBOWITZ

President, Old Mutual (Bermuda) Ltd.

July 11, 2006

Chairman Shelby, Ranking Member Sarbanes and Members of the Committee, my name is Alan Liebowitz, and I am President of Old Mutual (Bermuda) Ltd., an insurance company affiliated with the Old Mutual Financial Network. Old Mutual is a global diversified financial services network that extends from Europe to Asia, Africa and North America. In the United States, the Old Mutual Financial Network provides retirement savings and financial protection products in all 50 States through Fidelity & Guaranty Life, Americom Life & Annuity, and Fidelity & Guaranty Life of New York. Our life insurance companies have combined assets of over $12 billion and serve nearly 650,000 policyholders.

I am here today on behalf of the American Bankers Insurance Association (ABIA), the insurance affiliate of the American Bankers Association (ABA). ABIA's members are banking institutions that are engaged in the business of insurance and insurance companies and administrators that provide insurance products or services to banks. Together with our colleagues at the American Council of Life Insurers, the

American Insurance Association, the Council of Insurance Agents and Brokers and many other trade associations, ABIA and ABA participate in the Optional Federal Charter Coalition.

I began my professional career as a lawyer in a firm specializing in insurance regulatory matters. I dealt primarily with insurance departments on company formation, licensing and corporate governance. From there, I became general counsel to a New York domiciled life insurer where I dealt with all legal issues including licensure in 17 states, policy drafting, filing and advertising compliance.

I joined the largest U.S. bank holding company in 1985 and for 15 years represented it on insurance related issues including the Bank Holding Company Act and 50 state insurance laws. It was during this period that the contrast between bank and insurance regulatory schemes became starkly evident. It became abundantly clear to me that consumers were not benefiting from the insurance regulatory system and, in fact, were being denied access to more affordable and creative products by virtue of the constraints placed on insurers in the name of consumer protection. I see very little today indicating that this deficiency has been addressed. What changes have occurred have taken place at the margins of reform, have been incomplete and have only been in response to congressional action.

Since 2000 I have been president of Old Mutual (Bermuda) Ltd., a Bermuda domiciled insurer that focuses on delivering primarily U.S. capital market based products around the world through financial institution distribution. This experience has made me familiar with the insurance laws of many countries, including the United Kingdom, Hong Kong, the Middle East, Israel, Mexico and various Latin American countries.

The differences between foreign insurance regulatory structures and our own are as stark as the differences between our banking and insurance systems. In these countries, unlike the United States, insurance regulation is uniform. As a result, consumers and insurers are not subject to policy or pricing differences simply because of their location. Meaningful reform to the insurance regulatory system must be instituted in the United States to keep our home markets healthy and to address the growing competitive disparity between our domestic market and the markets of other nations. To me, the problem is simple: the states seem capable of only debating reform; instituting reform occurs only when Congress acts.

No where is this more true than in the three regulatory areas most at issue for bankers selling insurance products: producer or agent licensing, product availability and price controls. These regulatory functions are executed differently in every one of the 56 U.S. jurisdictions. Regulating insurance in this fashion is inefficient and provides little benefit to the consumer. For example, after centuries of experience watching free markets efficiently determine prices for other products to the overwhelming benefit of consumers, we in the United States continue to allow the states to set the price of insurance products. In addition, there is no uniform product regulation whatsoever among all 50 states. And, perhaps most importantly, it took an act of Congress before 40 states—and to date only 40 states—instituted a reciprocal, but not uniform, agent licensing system.

Problems with the Current Insurance Regulatory System

Producer Licensing

Creating a single standard for licensing agents should have been easy. It should have been work the states completed more than a century ago but little was done about instituting uniform agent licensing until 1999 when passage of the Gramm-Leach-Bliley Act (GLBA) forced the states to adopt act. In 2000, the National Association of Insurance Commissioners (NAIC) said its goal was the “implementation of a uniform, electronic licensing system for individuals and business entities that sell, solicit or negotiate insurance.” Six years later, that goal has yet to be realized.

Currently, different States impose different qualification and testing standards and different continuing education requirements on producers. Licenses recognized in one State are not necessarily recognized in another State. Worse, agents associated with banks are sometimes subject to sales limitations not applicable to agents who are unassociated with banks. For banks that operate agent networks in multiple States, these differences impose compliance costs and other financial burdens that are significant and, ultimately, borne by consumers.

In 1999, as part of GLBA, Congress adopted a requirement designed to promote the adoption of uniform agent licensing rules by the states. The so-called NARAB provision of GLBA required the establishment of an organization to develop uniform licensing rules and regulations, but only if a majority of the States did not adopt either uniform or reciprocal licensing laws and regulations within 3 years of the date of enactment of GLBA. To facilitate compliance with GLBA, the NAIC developed a reciprocal licensing Model Act, which has currently been adopted by about

40 States. Because the States could avoid NARAB—and the uniformity mandate it represented—if only a majority of States enacted the Model, that action by a majority of States has allowed some States, including some of the largest States like California, to avoid the issue of licensing reform entirely.

And, the more important goal of achieving licensing uniformity has been put off indefinitely. GLBA allowed the goal of uniform agent licensing laws to remain unrealized so long as a majority of States passed reciprocal licensing laws. Unfortunately, reciprocity is not uniformity. Instead, it is the recognition and acceptance of differences among States. Seven years after passage of GLBA, significant differences in State licensing laws remain.

To solve this problem, I recommend adoption of a uniform agent licensing standard, preferably through the creation of an Optional Federal Charter. The proposed National Insurance Act, S. 2509, introduced by Senator John Sununu (R-NH) and Senator Tim Johnson (D-SD), creates a uniform agent licensing standard by allowing agents to apply for a National Producer License. This national license would allow an agent to sell insurance products anywhere in the United States and would not compel the states to change their laws at all. By definition, the National Insurance Act creates a regulatory framework for insurance much like the dual banking system with which we are all familiar. While the licensing provisions establish a national producer's license, they do not require state-licensed agents to obtain that license in order to sell the products of federally chartered insurers.

The result is a competitively neutral agent licensing regime. Agents who desire only a state license will be able to sell exactly the same array of products in their state as a federally licensed agent operating in the same state. Alternatively, an agent who needs to sell products in multiple states will not have to obtain the individual state licenses offered by every state but may instead obtain the Federal license offered under this Act. By offering the Federal license as an option to the existing system of state licenses, the Act preserves the authority of states to regulate agents licensed in their states but also allows those desirous of the efficiency a single Federal license offers the ability to obtain one.

Rate Regulation

Three basic components are necessary to provide for the insurance needs of consumers: an agent has to be licensed to sell insurance products, there have to be products to sell and those products must be at prices consumers can afford. Price controls have long been thought to satisfy this latter requirement but, in fact, they work against consumers' interests in the overwhelming majority of cases.

In most States, an insurance product can only be sold after the State insurance regulator approves the price of an insurance product. Some States regulate the price of an insurance policy; some States regulate the loss ratio a given product line must maintain. Generally, the effect of price controls has been higher prices and fewer choices. When prices are set artificially high, consumers are denied access to lower costs even if there is a willing seller. When price controls are set artificially low, the number of willing sellers is reduced resulting in greatly diminished consumer choice.

Price controls are only appropriate, arguably, when associated with a utility or a monopoly. In such situations, a single company could set and hold prices at unreasonable levels. The insurance industry, however, is a competitive industry. There are thousands of insurers operating in the United States, and the only significant barrier to entry for new companies is the cost of compliance with the kaleidoscope of state insurance regulations and the inability to adjust prices based on market forces. In such a competitive market, competition among firms will protect consumers from unfair pricing schemes much more efficiently than the government. More importantly, allowing markets to set prices efficiently controls risk by making riskier choices more expensive.

The consumer benefits associated with competitive rates are more than just speculative. Several States already have moved away from rate regulation and, in those States, there is evidence that rates have fallen on certain products. A study by Scott Harrington for the AEI-Brookings Joint Center for Regulatory Studies entitled "Insurance Deregulation and the Public Interest" found that auto insurance is less costly and more available in 14 States that do not require prior approval of rates than in 27 other States that do require prior approval.

I have arrived at the same conclusion as Mr. Harrington. As a nation, we allow markets to set the price of housing, food and clothing, necessities more instrumental to the survival of most of us than insurance products. There is no basis for allowing the government to continue setting prices for insurance products when it's clear we are only saving consumers from lower prices and more choices.

Product Approval

Similar to price controls, most States' insurance departments won't approve an insurance policy for sale unless subject to prior review by the insurance regulator. ABIA's members have found that the impediments created by most States' prior approval requirements have had the undesirable effect of depriving consumers of innovative insurance products and retarded the ability of insurers to develop these products in a timely fashion.

Under the current State system of insurance regulation, it can take months, and sometimes years, for a company to receive permission from State insurance regulators to introduce a new product in every State. Such delays are an inevitable result of a system in which every State has an opportunity to review and approve insurance products and where the standards of review are different in every State. If the insurance industry cannot gain some relief from the States' prior approval regime, life insurers will continue to lose market share to other non-insurance investment products and property and casualty insurers will reduce or eliminate their efforts to develop innovative products that offer more comprehensive benefits at lower costs.

To alleviate this problem I recommend adoption of an insurance regulatory system with many of the features of the current banking system. Instead of prior review of insurance forms, a system like the one proposed in S. 2509 should be adopted. Under such a system, the National Insurance Commissioner would establish regulations for insurance products, require forms to be filed with the Commissioner, examine insurers for compliance with these regulations and impose strong penalties for non-compliance. Senators Sununu and Johnson are not proposing de-regulation of insurance products but, instead, a more permissive system patterned after banking regulation and designed to promote, rather than stifle, innovation.

Consumer Benefits of Creating an Optional Federal Charter

ABIA's member companies design systems and products to suit the needs and demands of consumers. Accordingly, we recognize that any insurance modernization proposal must be responsive to those needs and demands. The proposed National Insurance Act introduced by Senator Sununu and Senator Johnson will advantage consumers by allowing them access to a wider array of products at more competitive prices. The proposed legislation will also ensure that companies are more financially sound, and that the United States insurance industry is better represented abroad. Foreign financial regulators tend to agree: Commenting in the Financial Times last week, Sir Howard Davies, Director of the London School of Economics and a former chair of Britain's Financial Services Authority, observed that,

> There is no Federal regulator or Federal charter available to U.S. companies. As a result, there is a lack of leadership in insurance regulation nationally and internationally. This is unfortunate when insurers are engaged in far more complex financial transactions than they used to be. Many U.S. insurers would welcome the opportunity to seek Federal oversight: the Treasury could make it possible for them to do so. A positive side-benefit would be to strengthen U.S. influence in the International Association of Insurance Supervisors and make it more effective in dealing with problems of unregulated insurers and reinsurers in offshore centres.

I agree with Sir Howard. Establishing an Optional Federal Charter will assist the United States in remaining globally competitive in two important ways. Firstly, the current regulatory system greatly impedes our ability to negotiate in the international regulatory arena. Whereas most countries are represented by a single Federal regulator, like in Great Britain, the United States is represented by a variety of state insurance regulators who, by definition, do not and cannot speak for the United States.

Second, the difficulty of entering the U.S. market under the current state regulatory system dissuades foreign capital from investing in the U.S. market, restricting overall insurance capacity, and reducing the number of insurance products available to U.S. consumers. It is simply the case that there are relatively few foreign companies willing to expend the time and resources necessary to navigate our confusing state regulatory system. By that measure, it is also the case that there are many American companies that do not have the resources to enter every state's market. In that regard, foreign insurers and small domestic insurers share the same problem: the benefit of entering every state's market does not equal its cost.

But, improving American competitiveness in the global insurance arena is only one welcome benefit of the proposed National Insurance Act. The real merit is in the myriad ways consumers are advantaged and I will detail them for you now.

Consumer Access to Sound Insurance Products

An insurance policy is a promise to pay benefits after a triggering event. An often overlooked consumer benefit in S. 2509 is the imposition of rigorous financial solvency standards for federally chartered insurers. These standards include risk-based capital requirements ensuring that National insurers are adequately capitalized; Investment standards ensuring that National insurers invest their assets prudently; and, dividend restrictions, which prevent insolvent National insurers from paying dividends. Such standards should give consumers confidence that a federally chartered insurer will be able to pay claims on its policies.

The proposed National Insurance Act ensures Federal solvency standards are met by requiring regular examinations and setting forth enforcement measures for non-compliance. These examination and supervisory powers are designed to ensure that federally chartered insurers are safe and sound. Examination and enforcement standards contained in S. 2509 include: the authority to require federally chartered insurers to file regular reports on their operations and financial condition; the authority to regularly examine federally chartered insurers, and to the extent appropriate, their affiliates; and the authority to initiate an enforcement action against federally chartered insurers that fail to comply with applicable standards. Enforcement penalties are patterned after those available to Federal banking regulators, which include the power to remove officers and directors and to impose civil money penalties of up to $1 million a day.

These standards are significantly more stringent than what exists at the state level today.

More Rigorous Market Conduct Standards

The proposed National Insurance Act also protects consumers through Federal market conduct standards. Currently, market conduct exams are performed inconsistently by each state's insurance regulator. Some states are rigorous; some states are not. Some states impose market conduct examinations on insurers and insurance brokers by requiring them to hire a consultant selected by the states. The proposed National Insurance Act would protect consumers by preventing unfair methods of competition and unfair and deceptive acts and practices in the advertising, sale, issuance, distribution and administration of insurance policies through a single, uniform examination standard, a routine examination cycle and strict penalties for non-compliance.

Critics of optional Federal chartering often claim that a Federal insurance regulator would not be able to adequately police sales and claims practices by National insurers or producers. The Federal regulation of the banking industry shows that Federal agencies can effectively enforce consumer protection standards.

Today, thousands of banks are offering a variety of products to consumers through hundreds of thousands of branches, ATMs, loan production offices and other outlets throughout the United States. These banks are subject to Federal consumer protection statutes such as the Truth-in-Lending Act, the Truth-in-Savings Act, the Fair Credit Reporting Act, the Equal Credit Opportunity Act and many others. The Federal banking agencies, which are responsible for enforcing compliance with these various consumer protection laws, have been able to fully and effectively enforce compliance with the laws. They have done so through a combination of regular examinations backed up by the threat of enforcement actions. Federal market conduct standards for insurers backed by examinations and the threat of enforcement should work equally well for consumers of insurance.

Consumer Benefits of Uniformity

Nationwide uniformity of policies and sales practices that would be created by S. 2509 reduces consumer confusion, especially for those consumers who move from State to State for professional or personal reasons. Under the proposed National Insurance Act, the same life insurance policy could be offered in every State. Companies could use the same policy form, same disclosure statements, and same administrative procedures throughout the United States. A consumer who moved from New Jersey to New York, and then to Connecticut would have the same purchasing experience in each state if the product being offered was issued by a National insurer.

Uniform regulation also facilitates delivery of insurance products over the Internet. As we all know, the Internet can reach consumers, regardless of where they are located. To date, however, the use of the Internet to deliver insurance products has been complicated by variations in State insurance sales laws. A single Federal sales practice standard applied nationwide would eliminate such complications. This would expand consumer access to insurance products through the Internet. The proposed National Insurance Act would make expanded Internet sales a reality.

Conclusion

ABIA has concluded that the current insurance regulatory system is badly in need of reform and, judging by the organizations represented here today, we are not alone in that conclusion. Virtually all industry participants and even insurance regulators have spent years detailing the failings of the State system. The question, therefore, is not if the system needs reform but how to reform it. Some organizations would prefer to let the states continue the unacceptably slow process of reforming themselves. Others believe Congress should impose Federal insurance standards on the states. We believe Senator Sununu and Senator Johnson have defined the appropriate solution; namely, an Optional Federal Charter for insurers and insurance producers. The "Optional Federal Charter" solution addresses the shortcomings of the existing State insurance regulatory system by creating a national regulatory framework, yet preserves the State system for those who prefer it.

The proposed National Insurance Act is the path forward and we urge the Committee to consider it at its next opportunity.

PREPARED STATEMENT OF ROBERT A. WADSWORTH

CHAIRMAN AND CEO, PREFERRED MUTUAL INSURANCE COMPANY

JULY 11, 2006

Good morning Chairman Shelby, Ranking Member Sarbanes and Members of the Committee. My name is Bob Wadsworth, and I am pleased to testify today on behalf of the National Association of Mutual Insurance Companies regarding insurance regulation reform. Founded in 1895, NAMIC is the Nation's largest property and casualty insurance company trade association, with more than 1,400 members underwriting more than 40 percent of the property-casualty insurance premium written in the United States.

I am the Chairman and Chief Executive Officer of Preferred Mutual Insurance Company, a multi-State writer located in New Berlin, New York. Preferred Mutual writes more than $197 million in premium across four states. I also currently serve as Chairman of NAMIC.

NAMIC appreciates the opportunity to testify at this important hearing. It comes at a critical time in insurance regulation. The present system of state regulation is too slow and cumbersome and often denies consumers the benefits of competition. Consumers and insurers have a shared interest in a modernized system of regulation that will facilitate the bringing of new products to market in a timely fashion and assure that they are competitively priced.

The question is how best to achieve these goals. NAMIC believes that reform at the state level is more likely to produce better results than Federal involvement in insurance regulation. Let me explain why NAMIC takes this position, as opposed to some other trade associations, including some property-casualty trade associations.

NAMIC and the Role of Mutual Insurers

The great majority of our members are mutual insurers, companies that do not have shareholders, but are controlled by and operated for policyholders. The first successful insurance company formed in the American colonies was actually a mutual: The Philadelphia Contributionship for the Insurance of Houses from Loss by Fire. It was created in 1752 after Benjamin Franklin and a group of prominent Philadelphia citizens came together to help insure their properties from fire loss. The company is still in business today and is a NAMIC member.

In those early days before America declared its independence from British rule, most insurance companies followed the Contributionship model; that is, groups of neighbors typically formed entities to help each other avoid the certain financial ruin that would befall them if their properties were destroyed by fire. The other predominate type of insurance company is the stock company, which is owned by its shareholders.

NAMIC members account for 47 percent of the homeowners market, 39 percent of the automobile market, 34 percent of the workers' compensation market, and 32 percent of the commercial property and liability market.

The History of Insurance Regulation

Since the beginning of the property-casualty insurance business, it has been regulated at the state level. In 1944, the U.S. Supreme Court in the South Eastern Underwriters case found that insurance was a business in interstate commerce that could be regulated by the Federal Government. The Congress responded by enacting the McCarran-Ferguson Act in 1945 which declared that "[T]he business of insur-

ance, and every person engaged therein, shall be subject to the laws of the several States.” The only exception to this rule is where the Congress enacts legislation that “specifically relates to the business of insurance.” Since 1945, with few exceptions, insurance has been regulated at the state level.

NAMIC believes that state regulation has generally served both consumers and insurers well over the years, particularly with respect to the property-casualty business. Unlike the life insurance business, the property-casualty insurance is primarily a state-based business. While some of our products cover interstate activities, most of our products that directly affect your constituents—auto, farm, and homeowners insurance—are single state products. As such, we believe the states have the best understanding of the products and the people for whom they provide protection.

Weaknesses of State Regulation

While the state regulatory structure has worked well for years, it has not always kept up with changing times. Insurers, large and small alike, need several changes in the regulatory structure in and among the states if they are to provide customers with the products they need at the lowest possible prices.

First and foremost among needed changes is an end to price regulation of all lines of property-casualty insurance. Only one state, Illinois, allows personal automobile and homeowners insurers to set prices through what is known as “open competition.” While some other states have made notable progress in this area, particularly on the commercial side, the fact remains that auto insurance is the only product in America with multiple sellers whose price is regulated by the government rather than by the marketplace. We trust people to make decisions that can have a far greater impact on their lives—such as their health plans and retirement investments—without government control as to the prices that can be charged. We understand the political sensitivity to permitting property-casualty insurers to compete on the basis of price, but we submit that it is an historical anachronism that is at odds with the faith we place in individuals and a free marketplace throughout the American economy.

A brief review of state experience with different approaches to pricing is instructive. The experience in Illinois, an open competition state since 1969, shows the benefits of unregulated prices—stable rates and low residual markets because the Illinois market attracts the largest share of all private passenger auto and homeowner insurers in the Nation. Other examples abound. South Carolina has adopted a flex-rating system for personal lines and has seen prices fall and new insurers enter the market. The recent reforms in New Jersey, once cited as the poster child for over-regulation, have produced similar results. In nearly every state that has adopted market-based rating schemes, the market has improved.

On the other hand, almost every state that has availability or affordability problems suffers from overregulation and price controls. Massachusetts, a strict prior approval state, now has only 18 insurers selling private passenger auto insurance; Illinois has hundreds. Far too often, policymakers in these troubled jurisdictions react by placing a tighter regulatory grip on the market, which usually leads more insurers to leave the state, thus exacerbating availability and affordability problems.

California, in contrast, is often cited as a success by proponents of strict rate regulation. A careful analysis of the California situation, however, demonstrates that rate regulation ultimately works against consumers, just as Federal restrictions on the rate of interest banks could offer on deposits into the 1980s harmed bank customers. California aggressively regulates pricing, especially for auto insurance. Its recent rate experience is better than that of most states, meaning that premiums there are relatively low compared to similarly situated states. Supporters of rate regulation attribute this to Proposition 103, a ballot initiative passed in 1988 that mandated auto insurance rate rollbacks and established a prior approval system of rate regulation. In reality, California’s relatively low auto insurance rates are almost entirely the result of that state’s Supreme Court overturning its own previous decision to permit individuals to file so-called third-party bad faith suits against the at-fault driver’s auto insurer.

This decision was handed down in 1988, the same year that Proposition 103, calling for strict regulation of the industry, was adopted. The highly respected RAND Institute for Civil Justice found that the third party bad faith claims permitted before the 1988 decision increased bodily injury liability premiums by 32 (low estimate) to 53 (high estimate) percent. Thus, when these suits were barred there was a dramatic reduction in the cost of bodily injury liability claims. However, because of the difficulties of changing rates in the strict prior approval regime of Prop 103, insurers did not lower premiums commensurately, resulting in increased insurer profits. Thus, it is a reasonable conclusion that the result of the restrictive Prop 103

ratemaking system has been higher, not lower, rates for California insureds than they would have experienced had Prop 103 not been adopted.

While insurance price controls are the most troublesome feature of state insurance regulation, there are many others that deserve attention. These include the lack of uniformity among states with respect to routine matters such as producer licensing and form filing; underwriting restrictions that prevent insurers from accurately assessing risk; blanket coverage mandates that force insurers to provide coverage for particular risks they may not wish to cover, and for which consumers may not be willing to pay; and arbitrary and redundant "market conduct examinations" that cost insurers enormous sums that could otherwise be used to pay claims

Because of these and other problems, some very large insurance companies, including some of our members, are now asking for a Federal regulator that would pre-empt the states' ability to regulate all insurers.

The Strengths of State-Based Regulation

Notwithstanding the misguided laws and regulations that plague insurance markets in many states, the decentralized system of state-based insurance regulation has inherent virtues that would be lacking in a national insurance regulatory system. State insurance regulation has the capacity to adapt to local market conditions, to the benefit of consumers and companies, and affords states the opportunity to experiment and learn from each other.

A state insurance commissioner is able to develop expertise in issues that are particularly relevant to his or her state. Unlike banking and life insurance, property-casualty insurance is highly sensitive to local risk factors such as weather conditions, tort law, medical costs, and building codes. Many state building codes are tailored to the risk found in that state. In the Midwest, the focus is on damage from hail and tornados, while codes in coastal regions focus on preventing loss from hurricanes. In other states, seismic concerns dictate the type of construction. All these factors are considered by insurers in assessing risk and pricing insurance products. State insurance regulation is able to take account of these state and regional variations in ways that Federal regulation would not.

Insurance consumers directly benefit from state regulators' familiarity with the unique circumstances of their particular states. Over time, each state's insurance department has accumulated a level of "institutional knowledge" specific to that state. Historically, state regulators have drawn upon that knowledge to develop consumer assistance programs tailored to local needs and concerns. Compared to a Federal regulator, state regulators have a greater incentive to deal fairly and responsibly with consumers. Twelve state insurance departments are headed by commissioners who are directly elected by their states' voters; the others serve at the pleasure of Governors who also must answer to voters. A Federal regulator, by contrast, would be far less accountable to consumers in particular states, and would thus have less motivation to be responsive to their needs.

Is There a Need for Federal Regulation?

NAMIC believes that the answer to this question lies in both an examination of how the states are responding to the problems outlined in the previous section and the likely outcome of Federal legislation.

State Reforms

States have not been oblivious to the criticisms leveled against them. They have made significant progress in addressing antiquated rules such as those involving price controls and company licensing restrictions. The results in recent years have been encouraging. On the matter of price regulation,

- Nine states have adopted flex-band rating systems for property-casualty products to replace the rigid system of price controls.
- Fourteen states have adopted the more flexible use and file system.
- Twenty four states have established no filing requirements, mostly for large commercial risks.
- Only 16 states still require statutory prior approval. Several of these states, however, are among the largest in the country, accounting for 40.8 percent of the total auto insurance market and 41.4 percent of the total homeowners insurance market nationwide.
- With respect to insurer licensing, the Uniform Certificate of Authority Application (UCAA) is now used in all insurance jurisdictions.
- A system of electronic filing has been implemented by most states and has streamlined the process by which rates and forms are filed by companies.

- Twenty-seven states have now adopted the Life Insurance Interstate Compact, which allows the compact to now function and serve as a single point of filing for life insurance products.
- The National Conference of Insurance Legislators (NCOIL), the National Conference of State Legislatures (NCSL) and the American Legislative Exchange Council (ALEC) have all endorsed competition as the best regulator of rates. NCOIL has adopted a significant model law that would create a use and file system for personal lines and an informational filing system for commercial lines.
- NCOIL has also adopted a Market Conduct Model Law that would bring significant reform to that area of state regulation.

The Risks of Federal Regulation

There are many options that Federal policymakers can take, from broader approaches such as a complete Federal takeover or an optional Federal charter to the narrower approaches pursued by the House Financial Services Committee in its different SMART bill drafts and in H.R. 5637, the Nonadmitted and Reinsurance Reform Act .

The Sununu-Johnson bill (S. 2509), titled the "National Insurance Act of 2006," would establish an optional Federal charter modeled on bank regulation. In essence, the bill would allow every insurer to choose whether to be regulated by the states or by a new Federal regulatory system to be administered by an Office of National Insurance. NAMIC is deeply concerned that the optional Federal charter proposal could lead to negative outcomes that would far outweigh any potential benefits, and that many of those benefits will not be realized.

In theory, an optional Federal charter might increase competition among multi-State insurers by streamlining and centralizing insurance regulation. It might exempt federally chartered insurers from notoriously inefficient and archaic rate regulation, which serves mainly to force low-risk policyholders to subsidize high-risk policyholders. In theory, it might promote regulatory competition between Federal and state regulators, with each striving to create regulatory regimes that provide the greatest benefit to insurers and consumers alike.

The problem, as we see it, is that in practice, optional Federal chartering might achieve few or none of these results, and that the potential risks are too great. Here are our greatest concerns:

The "Big Mistake"

Federal regulation has proven no better than state regulation at addressing market failures or protecting consumer interests and, unlike state regulatory failures, Federal regulatory mistakes can have disastrous economy-wide consequences. The savings and loan debacle of the 1980s that ended up costing taxpayers over $100 billion is the biggest such disaster in recent memory. When a state regulator makes a mistake, the damage is localized and can more easily be "fixed." Proponents of an optional Federal charter for insurance argue that congressional action could bring a system resembling that found in Illinois to the entire country. But it is entirely possible that the system that eventually emerges will instead resemble the highly regulated states. The fallout from a strict national regulatory climate could do serious harm to large sectors of the economy.

Negative Charter Competition

S. 2509 is modeled on the dual banking system, with a Federal analogue to the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS). That model is at best problematic. During the 1980s and 1990s, the OCC promulgated rules, regulations and orders expanding bank powers and limiting the applicability of state consumer protection laws (including those relating to predatory or sub-prime lending), thereby encouraging state-chartered banks to migrate to Federal charters. As the OCC is funded by the fees it charges the national banks it regulates, it had every reason to encourage state chartered banks to flip their charters and build the OCC's regulatory empire, at the expense of both consumers and taxpayers.

This was not a one-way street. State thrift supervisors also competed with the OTS for savings and loan charters and many of the most costly S & L failures were by state-chartered thrifts that had even broader powers than Federal S & Ls and were subject to very little supervision by their state regulators.

Social Regulation

NAMIC is also concerned that while proponents of Federal regulation may design a "perfect system," they can neither anticipate nor prevent the imposition of disastrous social regulation in exchange for the new regulatory structure.

While NAMIC favors price competition, we are not so naive as to believe that the same political dynamic that makes it so difficult to achieve price competition in the states will not recur during the debate on S. 2509 and its successors. Just as political expediency occasionally leads state office-holders and candidates to call for insurance price controls and rate rollbacks, we can easily imagine situations in which their Federal counterparts would be tempted to do the same. What we are likely to be left with, then, is no pricing freedom and more social regulation.

"Social regulation," as we use that term, encompasses any number of measures that tend to socialize insurance costs by spreading risk indiscriminately among risk classes. In particular, regulations that restrict insurers' underwriting freedom often have this effect. It is important to note that accurately assessing and classifying the risk of loss associated with particular individuals and properties is the sine qua non of the property-casualty insurance business. Without risk-based underwriting, the insurance enterprise cannot operate.

As Bob Litan of Brookings explained in a recent article,

> Individuals or firms with higher risks of claims . . . should pay higher premiums. If this were not the case—that is, if insurers required higher-risk customers to subsidize lower-risk customers—then insurers who provided coverage only to low-risk policyholders could underprice their competitors and capture just these customers, driving out their competitors in the process.

Government restrictions on underwriting freedom ostensibly guard against unfair business practices and ensure that insurance will be available to meet market demand. In many instances, however, the effect of these regulatory interventions is to create dysfunctional market conditions that lead to problems such as adverse selection and cross-subsidies. Adverse selection occurs when low-risk insureds purchase less coverage, and high-risk insureds purchase more coverage, than they would if the price of insurance more closely reflected the expected loss for each group. Government-imposed underwriting restrictions foster adverse selection by depriving insurers of the ability to distinguish between individuals who have a low probability of experiencing and those with a high probability of experiencing a loss.

By weakening the link between expected loss costs and premiums, underwriting restrictions create cross-subsidies that flow from low-risk insureds to high-risk insureds. S. 2509's promise of rate deregulation for federally chartered insurers will mean little if Federal regulators impose underwriting restrictions that impair the ability of insurers to charge premiums based on risk. There is nothing in S. 2509 to prevent this, and we find no reason to be optimistic that a Federal insurance regulator would voluntarily refrain from eventually restricting underwriting freedom. Indeed, even without explicit insurance regulatory authority, the Federal Government has attempted on various occasions to restrict the use of certain underwriting variables. In the 1990s, for instance, the Department of Housing and Urban Development launched a campaign to prevent insurers from using the age and value of a home to assess the risk of loss associated with residential properties. More recently, some Members of Congress have proposed placing limitations on insurers' freedom to underwrite and price life insurance based on foreign travel, despite the obvious risks in countries wracked by war, pestilence, uncontrollable viruses or natural disasters.

Such regulatory interference in the marketplace could ultimately make coverage less available and affordable for most consumers. We prefer that the states continue to work together to achieve greater regulatory uniformity.

The Potential for Dual Regulation

Proponents of an optional Federal charter argue that the legislation would simply create an alternative regulatory scheme for those who seek it. We believe that it could well result in dual regulation for insurers as it has for banks. Current banking law gives banks the choice of being regulated under either a Federal or state charter, but all banks are subject to some regulation by the Federal Deposit Insurance Corporation (FDIC), regardless of their charter. It is certainly within the realm of reality that in order for an Optional Federal Charter to work, Congress would eventually be forced to replace the state guaranty funds with a Federal insurance fund similar to the FDIC. If this occurs, insurers choosing to remain under state regulatory jurisdiction could nevertheless find themselves subject to a vast array of Federal rules, but would not enjoy the benefits of uniformity. Over time, the multi-State

writers would effectively be forced into the Federal system, leaving smaller companies with the states—in effect, creating adverse selection in regulation.

One must look only as far as the health insurance system to see the potential pitfalls of dual regulation. As you know, health insurance is regulated by both state and Federal law. This redundant regulatory scheme is partially responsible for the increasing costs of health insurance. It also has created a situation in which consumers seeking assistance from regulators are often caught between state and Federal agencies, depending on the problem at hand. The added costs of dual health insurance regulation are eventually passed on to consumers, as are all regulatory costs. Under an optional Federal charter for property-casualty insurance, consumers will likely suffer the same confusion that exists under the health insurance regulatory structure: Which problem falls under which jurisdiction? Whom do they call for help? What agency deals with what problem? Uncertainties that currently befuddle health insurance consumers could easily recur under a dual property-casualty regulatory system.

The Illusion of "Choice"

In theory, an optional Federal charter could promote regulatory competition between state governments and the Federal Government. Such competition would provide strong motivation for further state reforms, and would deter the Federal insurance regulator as well as state regulators from undertaking excessively burdensome market interventions.

But regulatory competition will work only if most insurers can switch charters at relatively low cost. In fact, the largely fixed costs of adopting a Federal charter are likely to be quite high, and switching back to a state charter could be even more expensive. As a practical matter, thousands of small to medium sized insurers would find themselves trapped in the regulatory system they initially chose because they would be unable to absorb the costs associated with switching between regulatory regimes. The result would be an unlevel playing field on which only the largest insurers would have the financial wherewithal to choose the regulatory regime that happened to be most hospitable at any given time. Moreover, the inability of most insurers to switch readily between state and Federal regulation would undermine the regulatory competition that supporters envision.

In sum, an optional system would not necessarily result in the optimal system, particularly over time. As with the banking system, it would generally mean that the large insurers would opt for the Federal system and the small ones would be left in the state system and may be subject to dual regulation. Perhaps the goals of S. 2509 could be better met by using the Congress' powers to improve the state systems instead. We offer one such approach in the next section of the testimony.

If Not OFC, What Can Be Done?

As I indicated earlier, the "shotgun" approach to insurance regulatory reform embodied in the optional Federal charter proposal would bring uncertain benefits while potentially creating a variety of negative consequences. I have also indicated that government rate regulation and restrictions on underwriting freedom pose the greatest impediments to the creation of healthy, competitive property-casualty insurance markets. If Congress wishes to eliminate these defects, it may do so without establishing a Federal insurance regulatory authority or by mandating an extensive overhaul of the state-based system of insurance regulation. Instead, it might consider a simple piece of legislation that would do just two things:

1. Prohibit states from limiting property-casualty insurers' ability to set prices for insurance products, except where the insurance commissioner can provide credible evidence that a rate would be inadequate to protect against insolvency.
2. Prohibit states from limiting or restricting the use of underwriting variables and techniques, except where the insurance commissioner can provide credible evidence that a challenged variable or technique bears no relationship to the risk of future loss.

In conclusion, NAMIC believes that the states have not acted as rapidly and as thoroughly to modernize insurance regulation as we believe is necessary, but we are encouraged that they have picked up the pace of reform and are headed in the right direction. The states need more time and perhaps a Federal prod to complete the job. Given this recent progress and the risks associated with creating an entirely new Federal regulatory structure, NAMIC is convinced that reform at the state level is the best and safest course for consumers and insurers alike.

PREPARED STATEMENT OF TRAVIS PLUNKETT

LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

JULY 11, 2006

Mr. Chairman and Members of the Committee, thank you for your invitation to testify today. America's insurance consumers, including small businesses, are vitally interested in how insurance will be regulated in the future. Therefore, your hearing is timely. We especially appreciate the fact that the Committee is beginning its review with an overall examination of insurance regulation—why it exists, what are its successes and failures—rather than solely reviewing proposed legislation, such as the Oxley-Baker "SMART" proposal or the optional Federal charter approach.[1] In order to determine whether Federal legislation is necessary and what should be its focus, it obviously makes a great deal of sense for the Committee to first conduct a thorough assessment of the current situation. If the "problems" with the present insurance regulation regime are not properly diagnosed, the "solutions" that Congress enacts will be flawed.

In this testimony, I will first discuss why regulation of the insurance industry is necessary, including a review of the key reasons regulation is required and why some current developments make meaningful oversight even more essential. I will then point out that consumers are agnostic on the question of whether regulation should be at the state or Federal level but we are very concerned about the quality of consumer protections that are in place, wherever the locus of regulation resides in the future. I will then list a few of the most pressing problems that insurance consumers are presently facing that require a regulatory response.

I then provide a brief history if the insurance industry's desire for Federal regulation in the early years of this country and the reasons why the industry switched to favoring state regulation in the later half of the 19th century. The industry is now split on the question of whether state-based regulation should continue. I will point out that the industry has generally shifted its allegiance over the years to support the oversight by the level of government that imposes the weakest regulatory regime and the fewest consumer protections.

I explain why market "competition" alone cannot be relied upon to protect insurance consumers. The absence of regulatory oversight for policy forms (*i.e.*, coverages) and risk classifications (*i.e.*, how consumers are grouped for the purpose of charging premiums) often leads to a hollowing out of coverage offered in insurance policies, unfair discrimination and the abdication of the insurance system's primary role in loss prevention. Industry proposals for deregulation—euphemistically termed "modernization"—will likely increase problems with insurance availability and affordability and further erode incentives for loss prevention. Industry claims that competition is incompatible with regulation are not borne out by the facts. The experience in states like California demonstrates that appropriate regulation enhances competition, requires insurers to compete fairly and in a manner that benefits consumers and results in a generous return for these companies.

I then set forth the principles for a regulatory system that consumers would favor, showing ways to achieve regulatory uniformity without sacrificing consumer protections.

Finally, I briefly discuss some of the regulatory proposals put forth in recent years by the insurers, including the optional Federal charter approach and the SMART Act, both of which CFA strongly opposes. We do indicate support for repeal of the McCarran-Ferguson Act's broad antitrust exemption that insurers enjoy, as it allows them to collude in pricing and other market decisions.

Why Is Regulation of Insurance Necessary?

The rationale behind insurance regulation is to promote beneficial competition and prevent destructive or harmful competition in various areas.

Insolvency

One of the reasons for regulation is to prevent competition that routinely causes insurers to go out of business, leaving consumers unable to collect on claims. Insolvency regulation has historically been a primary focus of insurance regulation. After several insolvencies in the 1980s, state regulators and the National Association of Insurance Commissioners (NAIC) enacted risk-based capital standards and implemented an accreditation program to help identify and prevent future insolvencies. As fewer insolvencies occurred in the 1990s through to today, state regulators appear to be doing a better job.

[1] CFA strongly opposes both of these proposals as undermining needed consumer protections.

Unfair and Deceptive Policies and Practices

Insurance policies, unlike most other consumer products or services, are contracts that promise to make certain payments under certain conditions at some point in the future. (Please see the attached fact sheet on why insurance is different from many other products for regulatory purposes.) Consumers can easily research the price, quality and features of a television, but they have very limited ability to do so on insurance policies. Because of the complicated nature of insurance policies, consumers rely on the representations of the seller/agent to a far greater extent than for other products. Regulation exists to prevent competition that fosters the sale of unfair and deceptive policies and claims practices.

Unfortunately, states have not fared as well in this area. Rather than acting to uncover abuses and instigate enforcement actions, states have often reacted after lawsuits or news stories brought bad practices to light. For example, the common perception among regulators that "fly by-night" insurance companies were primarily responsible for deceptive and misleading practices was shattered in the late 1980s and early 1990s by widespread allegations of such practices among household names such as MetLife, John Hancock, and Prudential. For instance, MetLife sold plain whole life policies to nurses as "retirement plans," and Prudential unilaterally replaced many customers' whole life policies with policies that didn't offer as much coverage. Though it is true that state regulators eventually took action through coordinated settlements, the allegations were first raised in private litigation; many consumers were defrauded before regulators acted.

The recent revelations and settlements by New York Attorney General Eliot Spitzer show that even the most sophisticated consumers of insurance can be duped into paying too much for insurance through bid-rigging, steering, undisclosed kickback commissions to brokers and agents and through other anticompetitive acts.

Insurance Availability

Some insurance is mandated by law or required to complete financial transactions, such as mortgage loans. In a normal competitive market, participants compete by attempting to sell to all consumers seeking the product. However, in the insurance market, participants compete by attempting to "select" only the most profitable consumers. This selection competition leads to availability problems and redlining.[2] Regulation exists to limit destructive selection competition that harms consumers and society.

Lawsuits brought by fair housing groups and the Department of Housing and Urban Development (HUD) over the past 15 years have revealed that insurance availability problems and unfair discrimination exist and demonstrate a lack of oversight and attention by many of the states. NAIC had ample opportunity after its own studies indicated that these problems existed to move to protect consumers. It retreated, however, when, a few years ago, the insurers threatened to cutoff funding for its insurance information data base, a primary source of NAIC income.

Serious problems with home insurance availability and affordability surfaced this spring along America's coastlines. Hundreds of thousands of people are having their homeowners insurance policies non-renewed and rates are skyrocketing. As to the decisions to nonrenew, on May 9, 2006, the Insurance Services Office (ISO) President and CEO Frank J. Coyne signaled that the market is "overexposed" along the coastline of America. In the National Underwriter article, "Exposures Overly Concentrated Along Storm-prone Gulf Coast" (May 15, 2006, Edition), the ISO executive

[2] The industry's reliance on selection competition can have negative impacts on consumers. Insurance is a risk spreading mechanism. Insurance aggregates consumers' premiums into a common fund from which claims are paid. Insurance is a contractual social arrangement, subject to regulation by the states.

The common fund in which wealth is shifted from those without losses (claims) to those with losses (claims) is the reason that the contribution of insurance companies to the Gross National Product of the United States is measured as premiums less losses for the property-casualty lines of insurance. The U.S. Government recognizes that the losses are paid from a common fund and thus are a shift in dollars from consumers without claims to those with claims, not a "product" of the insurance companies.

Competition among insurers should be focused where it has positive effects, *e.g.*, creating efficiencies, lowering overhead. But rather than competing on the basis of the expense and profit components of rates, the industry has relied more on selection competition, which merely pushes claims from insurer to insurer or back on the person or the state. States have failed to control against the worst ravages of selection competition (*e.g.*, redlining).

Some of the vices of selection competition that need to be addressed include zip code or other territorial selection; the potential for genetic profile selection; income (or more precisely credit report) selection; and selection based on employment. Targeted marketing based solely on information such as income, habits, and preferences, leaves out consumers in need of insurance, perhaps unfairly.

"cautioned that population growth and soaring home values in vulnerable areas are boosting carrier exposures to dangerous levels." He said, "The inescapable conclusion is that the effects of exposure growth far outweigh any effects of global warming."

Insurers have started major pullbacks in the Gulf Coast in the wake of the ISO pronouncement. On May 12, 2006, Allstate announced it would drop 120,000 home and condominium policies and State Farm announced it would drop 39,000 policies in the wind pool areas and increase rates more than 70 percent.[3] Collusion that would be forbidden by antitrust laws in most other industries appears to be involved in the price increases that have occurred. (See section entitled "Where Have All the Risk Takers Gone?" below.)

One obvious solution to discrimination and availability problems is to require insurers to disclose information about policies written by geo-code, and about specific underwriting guidelines that are used to determine eligibility and rates. Such disclosure would promote competition and benefit consumers; but state regulators, for the most part, have refused to require such disclosure in the face of adamant opposition from the industry. Regulators apparently agree with insurers that such information is a "trade secret" despite the absence of legal support for such a position. In addition, though insurance companies compete with banks that must meet data disclosure and lending requirements in underserved communities under the Community Reinvestment Act ("CRA"), insurers refuse to acknowledge a similar responsibility to communities.

Reverse Competition

In certain lines of insurance, insurers market their policies to a third party, such as creditors or auto dealers, who, in turn, sell the insurance to consumers on behalf of the insurer for commission and other compensation. This compensation is often not disclosed to the consumer. Absent regulation, reverse competition leads to higher—not lower—prices for consumers because insurers "compete" to offer greater compensation to third party sellers, driving up the price to consumers.

The credit insurance market offers a perfect example of reverse competition. Every few years, consumer groups issue reports about the millions of dollars that consumers are overcharged for credit insurance. Despite the overwhelming evidence that insurers do not meet targeted loss ratios in most states, many regulators have not acted to protect consumers by lowering rates.

The markets for low value life insurance and industrial life insurance are characterized by overpriced and inappropriately sold policies and a lack of competition. This demonstrates the need for standards that ensure substantial policy value and clear disclosure. Insurers rely on consumers' lack of sophistication to sell these overpriced policies. With some exceptions, states have not enacted standards that ensure value or provide timely, accurate disclosure. Consumers continue to pay far too much for very little coverage.

Information for Consumers

True competition can only exist when purchasers are fully aware of the costs and benefits of the products and services they purchase. Because of the nature of insurance policies and pricing, consumers have had relatively little information about the quality and comparative cost of insurance policies. Regulation is needed to ensure that consumers have access to information that is necessary to make informed insurance purchase decisions and to compare prices.

While the information and outreach efforts of states have improved, states and the NAIC have a long way to go. Some states have succeeded in getting good information out to consumers, but all too often the marketplace and insurance regulators have failed to ensure adequate disclosure. Their failure affects the pocketbooks of consumers, who cannot compare adequately on the basis of price.

In many cases, insurers have stymied proposals for effective disclosure. For decades, consumer advocates pressed for more meaningful disclosure of life insurance policies, including rate-of-return disclosure, which would give consumers a simple way to determine the value of a cash-value policy. Today, even insurance experts can't determine which policy is better without running the underlying information through a computer. Regulators resisted this kind of disclosure until the insurance scandals of the 1990s, involving widespread misleading and abusive practices by insurers and agents, prompted states and the NAIC to develop model laws to address these problems. Regulators voiced strong concerns and promised tough action to correct these abuses. While early drafts held promise and included some meaningful cost-comparison requirements, the insurance industry successfully lobbied against

[3] "Insurers Set To Squeeze Even Tighter," *Miami Herald,* May 13, 2006.

the most important provisions of these proposals that would have made comparison-shopping possible for normal consumers. The model disclosure law that NAIC eventually adopted is inadequate for consumers trying to understand the structure and actual costs of policies.

California adopted a rate of return disclosure rule a few years ago for life insurance (similar to an APR in loan contracts) that would have spurred competition and helped consumers comparison-shop. Before consumers had a chance to become familiar with the disclosures, however, the life insurance lobby persuaded the California legislature to scuttle it.

Are the Reasons for Insurance Regulation Still Valid?

The reasons for effective regulation of insurance are as relevant, or in some instances even more relevant, today than 5 or 10 years ago:

- Advances in technology now provide insurers access to extraordinarily detailed data about individual customers and allow them to pursue selection competition to an extent unimaginable 10 years ago.
- Insurance is being used by more Americans not just to protect against future risk, but as a tool to finance an increasing share of their future income, *e.g.*, through annuities.
- Increased competition from other financial sectors (such as banking) for the same customers could serve as an incentive for misleading and deceptive practices and market segmentation, leaving some consumers without access to the best policies and rates. If an insurer can't compete on price with a more efficient competitor, one way to keep prices low is by offering weaker policy benefits (*i.e.*, "competition" in the fine print).
- States and lenders still require the purchase of auto and home insurance. Combining insurer and lender functions under one roof, as allowed by the Gramm Leach Bliley Act, could increase incentives to sell insurance as an add-on to a loan (perhaps under tie-in pressure)—or to inappropriately fund insurance policies through high-cost loans.

As consumers are faced with these changes, it is more important than ever that insurance laws are updated and the consumer protection bar is raised, not lowered.

Given That Regulation Is Important for Consumers, Who Should Regulate—the States or the Federal Government?

Consumers do not care who regulates insurance; we only care that the regulatory system be excellent. Consumer advocates have been (and are) critical of the current state-based system, but we are not willing to accept a Federal system that guts consumer protections in the states and establishes one uniform but weak set of regulatory standards.

CFA's Director of Insurance, Bob Hunter, was one of very few people who have served both as a state regulator (Texas Insurance Commissioner) and as a Federal regulator (Federal Insurance Administrator when the Federal Insurance Administration was in HUD and had responsibility for the co-regulation of homeowners insurance in the FAIR Plans, as well as flood and crime insurance duties). His experience demonstrates that either a Federal or the state system can succeed or fail in protecting consumers. What is critical is not the locus of regulation, but the quality of the standards and the effectiveness of enforcement of those standards.

Both a state and a Federal system have potential advantages and disadvantages. Here are some of them:

Item	Federal	State
Experience overseeing all aspects of insurance regulation?	No	Yes
Responsive to local needs?	No	Yes
Handle individual complaints promptly and effectively?	No	Some States
Limited impact if regulatory mistakes are made?	No	Yes
Not subject to political pressure from national insurers?	No	No
Not subject to political pressure from local insurers?	Yes	No
Efficient solvency regulation?	Yes	Yes
Effective guarantee in event of insolvency?	Yes	No
Adequately restricts revolving door between regulators and industry?	Maybe	No
More uniform regulatory approach?	Yes	No
Can easily respond to micro-trends impacting only a region or a state?	No	Yes
Can easily respond to macro-trends that cross state borders?	Yes	No
Has greater resources, like date processing capacity?	Yes	No

Despite many weaknesses that exist in insurance regulation at the state level, a number of states do have high-quality consumer protections. Moreover, the states also have extensive experience regulating insurer safety and soundness and an established system to address and respond to consumer complaints. The burden of proof is on those who for opportunistic reasons now want to shift away from 150 years of state insurance regulation to show that they are not asking Federal regulators and American consumers to accept a dangerous "pig in a poke" that will harm consumers.

CFA agrees that better coordination and more consistent standards for licensing and examinations are desirable and necessary—as long as the standards are of the highest—and not the lowest—quality. We also agree that efficient regulation is important, because consumers pay for inefficiencies. CFA participated in NAIC meetings over many months helping to find ways to eliminate inefficient regulatory practices and delays, even helping to put together a 30-day total product approval package. Our concern is not with cutting fat, but with removing regulatory muscle when consumers are vulnerable.

Top Six Problems Consumers Have Today With Insurance

1. Insurers Are Increasingly Privatizing Profit, Socializing Risk and Creating Defective Insurance Products by Hollowing out Insurance Coverage and Cherry Picking Locations in Which They Will Underwrite

There are two basic public policy purposes of insurance. The first is to provide individuals, businesses and communities with a financial security tool to avoid financial ruin in the event of a catastrophic event, whether that event is a traffic accident, a fire or a hurricane. Insurers provide this essential financial security tool by accepting the transfer of risk from individuals and by spreading the individual risks through the pooling of very large numbers of individual risks. The pool of risks is diversified over many types of perils and many geographic locations.

The second essential purpose of insurance is to promote loss prevention. Insurance is the fundamental tool for providing economic incentives for less risky behavior and economic disincentives for more risky behavior. The insurance system is not just about paying claims; it is about reducing the loss of life and property from preventable events. Historically, insurers were at the forefront of loss prevention and loss mitigation. At one point, fire was a major cause of loss. This is no longer true, in large part due to the actions of insurers in the 20th century.

Left to a "competitive" or deregulated market, insurers are undermining these two core purposes of insurance. The remainder of this section discusses how insurers have hollowed out the benefits offered in many insurance policies so they no longer represent the essential financial security tool required by consumers and how insurers have pushed the risk of loss onto taxpayers through Federal or state programs. The most glaring example of these two actions is demonstrated by Hurricane Katrina. Losses covered by insurance companies were a minority fraction of the losses sustained by consumers because insurers had succeeded in shifting exposure onto the Federal Government through the flood insurance program,[4] onto states

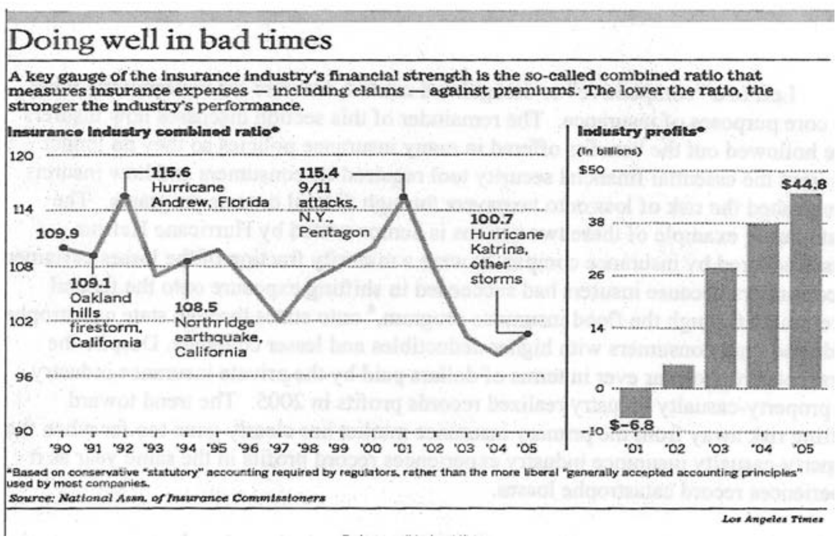
[4] The National flood Insurance Program has been in place since 1968 because insurers could not price or underwrite the risk. The program has now developed the information for such pric-

through state catastrophe funds and onto consumers with higher deductibles and lesser coverage. Despite the worst catastrophe year ever in terms of dollars paid by the private insurance industry, the property-casualty industry realized records profits in 2005. The trend toward shifting risk away from the primary insurance market has clearly gone too far when the property-casualty insurance industry experiences record profits in the same year as it experiences record catastrophe losses.

The critical conclusion to take from this section is that what the insurance industry calls "competition", which is essentially a completely deregulated market in which price collusion is not prevented by the application of antitrust law, will not protect consumers from unfair or unreasonable policy form or coverage decisions by insurers. The overwhelming evidence is that a market failure regarding policy forms and coverage has triggered a need for greater regulatory oversight of these factors to protect consumers.

Where Have All the Risk Takers Gone? Unaffordable Home Insurance That Covers Less and Less Risk.

In 2004, four major hurricanes hit Florida, but the property-casualty insurance industry enjoyed record profits of $38 billion. In 2005, Hurricane Katrina resulted in the highest hurricane losses ever, but the insurance industry also had another record year of profits, which reached $45 billion.[5] Here is a chart from a Los Angeles Times article on this subject:



Since the article was published, the property-casualty industry has reported the largest quarterly profit since ISO started keeping records in 1986. In the first quarter of 2006, the industry surplus rose by $13.0 billion to $440.1 billion.[6]

The property-casualty industry is overcapitalized because of all of the retained earnings it is accumulating. Today, the industry has $440 billion in capital, up from $297 billion in 2001. The net premium written to surplus ratio as of today is one to one, which means that for every dollar of premium that was sold, the industry had a dollar of surplus. Historically, this is an extremely safe leverage ratio. As a result, with the exception of property insurance on the nation's coasts, insurance prices are falling and coverage is easily available.[7]

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ing and underwriting and consideration should be given to returning some of this risk to private insurance control. The Federal program has had excessive subsidies and has been ineffective in mitigating risk as well as the private insurers could do it.

[5] Gosselin, Peter, "Insurers Saw Record Gains in Year of Catastrophic Losses," *Los Angeles Times,* April 5, 2006.

[6] "P/C Insurers Boost Underwriting Gain by 21 percent," *National Underwriter*, July 3, 2006.

[7] Council of Insurance Agents and Brokers, news release, "Commercial PC Rates Hold Flat or Drop Slightly for First Quarter 2006 Renewals, Council Survey Shows," April 19, 2006. According to the Council, commercial property-casualty rates held steady or fell slightly during the

Continued

Some might argue that insurers are risk takers. That may be true for the reinsurance industry, but it is certainly not true for the primary market. The primary market has succeeded in eliminating much risk. This is not an opinion, but a simple fact.

If one purchases a property-casualty insurance company's stock, with few exceptions, one has bought into a business that is lower in risk than the market in general, hurricanes notwithstanding. This is shown in any Value Line publication, which tests the riskiness of a stock. One key measure is the stock's Beta, which is the sensitivity of a stock's returns to the returns on some market index, such as the Standard & Poor's 500. A Beta between 0 and 1, such as utility stocks, is a low-volatility investment. A Beta equal to 1 matches the index. A Beta greater than 1 is anything more volatile than the index, such as a "small cap" fund.

Another measure of a shareholder's risk is the Financial Safety Index, with 1 being the safest investment and 5 being least safe. A third measure of risk is the Stock Price Stability reported in 5 percentile intervals with 5 marking the least stability and 100 marking the highest.

Consider these numbers from the Value Line of March 24, 2006, for Allstate, which has taken a leading role in claiming that catastrophe insurance is too risky for the private market alone to bear:

Beta = 0.90; Financial Safety = 2; Stock Price Stability = 90

The top 12 insurers in Value Line post these average results:

Beta = 0.95; Financial Safety = 2.2; Stock Price Stability = 84

By all three measures, property-casualty insurance is a below-average risk business: safer than buying an S&P 500 index fund. Another measure of insulation from risk is the record industry profits for 2004 and 2005 that have already been mentioned.

How did insurers do it? Some of the answers are clear:

First, insurers made intelligent use of reinsurance, securitization and other risk spreading techniques. That is the good news.

Second, after Hurricane Andrew insurers modernized ratemaking by using computer models. This development was a mixed blessing for consumers. While this caused huge price increases for consumers, CFA and other consumer leaders supported the change because we saw insurers as genuinely shocked by the scope of losses caused by Hurricane Andrew. Insurers promised that the model, by projecting either 1,000 or 10,000 years of experience, would bring stability to prices. The model contained projections of huge hurricanes (and earthquakes) as well as periods of intense activity and periods of little or no activity.

In the last few months, however, CFA has been shocked to learn that Risk Management Solutions (RMS) and other modelers are moving from a 10,000-year projection to a 5-year projection, which will cause a 40 percent increase in loss projections in Florida and the Gulf Coast and a 25–30 percent jump in the Mid-Atlantic and Northeast. This means that the hurricane component of insurance rates will sharply rise, resulting in overall double-digit rate increases along America's coastline from Maine to Texas. The RMS action interjects politics into a process that should be based solely on sound science. It is truly outrageous that insurers would renege on the promises made in the mid-1990s. CFA has called on regulators in coastal states to reject these rate hikes.

It is clear that insurance companies sought this move to higher rates. RMS's press release of March 23, 2006, states:

> Coming off back-to-back, extraordinarily active hurricane seasons, the market is looking for leadership. At RMS, we are taking a clear, unambiguous position that our clients should manage their risks in a manner consistent with elevated levels of hurricane activity and severity,' stated Hemant Shah, president and CEO of RMS. 'We live in a dynamic world, and there is now a critical mass of data and science that point to this being the prudent course of action.'

The "market" (the insurers) sought leadership (higher rates), so RMS was in a competitive bind. If it did not raise rates, the market would likely go to modelers who did. So RMS acted and other modelers are following suit.[8] It is simply uneth-

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first quarter of 2006, with renewal premiums for half of all account sizes remaining stable or dropping between 1 and 10 percent in the first 3 months of the year.

[8] According to the National Underwriter's Online Service on March 23, 2006, "Two other modeling vendors—Boston-based AIR Worldwide and Oakland, Calif.-based Eqecat—are also in the process of reworking their hurricane models."

ical that scientists at these modeling firms, under pressure from insurers, appear to have completely changed their minds at the same time after over a decade of using models they assured the public were scientifically sound. RMS has become the vehicle for collusive pricing.

In a third major development, insurers have not only passed along gigantic price increases to homeowners in coastal areas, but they have also sharply gutted coverage. Hurricane deductibles of two to 5 percent were introduced. Caps on home replacement costs were also added. State Farm has a 20 percent cap. Other insurers refuse to pay for any increased replacement costs at all, even though demand for home rebuilding usually surges in the wake of a hurricane, driving replacement costs up sharply. Insurers also excluded coverage for laws and ordinances, so that if a home has to be elevated to meet flood insurance standards or rewired to meet local building codes, insurers no longer have to pay.

Finally, insurers have simply dumped a great deal of risk, non-renewing tens of thousands of homeowner and business properties. Allstate, the leading culprit after Hurricane Andrew, is emerging as the heavy once more in the wake of Katrina. After Andrew, Allstate threatened to non-renew 300,000 South Floridians, provoking a state moratorium on such action. Today, Allstate is non-renewing even in Long Island.

These actions present a serious credibility problem for insurers. They told us, and we believed, that Hurricane Andrew was their "wake up" call, with the size and intensity surprising them and causing them to make these massive adjustments in price, coverage and portfolio of risk. What is their excuse now for engaging in another round of massive and precipitous actions?

Insurers surely knew that forecasters had predicted for decades that an increased period of hurricane activity and intensity would occur from the 1990s to about 2010. They also surely knew a storm of Hurricane Katrina's size, location and intensity was possible. The New Orleans Times-Picayune predicted exactly the sort of damage that occurred in a series of articles 4 years ago.[9]

Take Allstate's pullout from part of New York. It is very hard to look at this move as a legitimate step today when no pullout occurred after Hurricane Andrew. Why isn't the probability of a dangerous storm hitting Long Island already accounted for in the modeling—and rate structure—that were instituted after Hurricane Andrew? This type of precipitous action raises the question of whether Allstate is using the threat of hurricane damage as an excuse to drop customers they have had but do not want to retain for other reasons, such as clients in highly congested areas with poorer credit scores. Whether it was mismanagement that started a decade ago or the clever use of an opportunity today, consumers are being unjustifiably harmed. Insurance is supposed to bring stability, not turmoil, into peoples' lives.

2. The Revolution in Risk Classification Has Created Many Questionable Risk Characteristics, Generated New Forms of Redlining and Undermined the Loss Prevention Role of the Insurance System

As discussed above, one of the primary purposes of the insurance system is to promote loss prevention. The basic tool for loss prevention is price. By providing discounts for characteristics associated with less risky behavior and surcharges for characteristics associated with more risky behavior, the insurance system provides essential economic signals to consumers about how to lower their insurance costs and reduce the likelihood of events that claim lives or damage property.

Over the past 15 years, insurers have become more "sophisticated" about rating and risk classification. Through the use of data mining and third party data bases, like consumer credit reports, insurers have dramatically increased the number of rating characteristics and rate levels used.

We are certainly not against insurers using sophisticated analytic tools and various data bases to identify the causes of accidents and losses. We would applaud these actions if the results were employed to promote loss prevention by helping consumers better understand the behaviors associated with accidents and by providing price signals to encourage consumers to avoid the risky behaviors surfaced by this sophisticated research.

Unfortunately, insurers have generally not used the new risk classification research to promote loss prevention. Rather, insurers have used new risk classifications to undermine the loss prevention role of insurance by placing much greater emphasis on risk factors unrelated to loss prevention and almost wholly related to the economic status of potential policyholders. The industry's new approach to risk

[9] McQuaid, John; Schleifstein, Mark, "Washing Away" *New Orleans Times Picayune*. June 23–27, 2002.

classification is a form of redlining, where a host of factors are employed that are proxies for economic status and sometimes race.

For example, although Federal oversight of the impact of credit scores in insurance underwriting and rating decisions has been quite poor, [10] it is well-documented in studies by the Texas and Missouri Departments of Insurance that credit scoring is biased against low income and minority consumers. [11] And recently, GEICO's use of data about occupation and educational status has garnered the attention of New Jersey legislators. [12] But other factors have not received similar visibility. Several auto insurers use prior liability limits as a major rating factor. This means that for two consumers who are otherwise identical and who are both seeking the same coverage, the consumer who previously had a minimum limits policy will be charged more than the consumer who previously was able to afford a policy with higher limits. As with credit scoring and occupation/educational status information, this risk classification system clearly penalized lower income consumers.

Once again, deregulated "competition" alone will not protect consumers from unfair risk classification and unfair discrimination. Once again, this market failure demands close regulatory scrutiny of the use of risk classification factors when underwriting, coverage and rating decisions are made.

Let me present one more example of the illegitimate use of risk classification factors to illustrate our concern. Insurers have developed loss history data bases—data bases in which insurers report claims filed by their policyholders that are then made available to other insurers. Insurers initially used the claims history data bases—Comprehensive Loss Underwriting Exchange (CLUE) reports, for example—to verify the loss history reported by consumers when applying for new policies. However, in recent years, insurers started data mining these loss history data bases and decided that consumers who merely made an inquiry about their coverage—didn't file a claim, but simply inquired about their coverage—would be treated as if they had made a claim. Penalizing a consumer for making an inquiry on his or her policy is not just glaringly inequitable; it undermines loss prevention by discouraging consumers from interacting with insurers about potentially risky situations.

Although insurers and the purveyors of the claims data bases—including ChoicePoint—have largely stopped this practice after much criticism, simple competitive market forces without adequate oversight harmed consumers over a long period and undermined the loss prevention role of the insurance system. Moreover, as with the use of many questionable risk classification factors, competitive forces without regulatory oversight can actually exacerbate problems for consumers as insurers compete in risk selection and price poor people out of markets.

3. Insurance Cartels—Back to the Future

The insurance industry arose from cartel roots. For centuries, property-casualty insurers have used so-called "rating bureaus" to make rates for insurance companies to use jointly. Not many years ago, these bureaus required that insurers charge rates developed by the bureaus. (The last vestiges of this practice persisted into the 1990s.)

In recent years, the rate bureaus have stopped requiring the use of their rates or even calculating full rates because of lawsuits by state attorneys general. State attorneys general charged in court that the last liability insurance crisis was caused in great part by insurers sharply raising their prices to return to ISO rate levels in the mid-1980s. As a result of a settlement with these states, ISO agreed to move away from requiring final prices. ISO is an insurance rate bureau or advisory organization. Historically, ISO was a means of controlling competition. It still serves to restrain competition since it makes "loss costs" (the part of the rate that covers expected claims and the costs of adjusting claims) which represent about 60–70 percent of the rate. ISO also makes available expense data to which insurers can compare their costs in setting their final rates. ISO sets classes of risk that are adopted by many insurers. ISO diminishes competition significantly through all of these ac-

[10] Federal agencies with potential oversight authority paid virtually no attention to the possible disparate impact of the use of credit scoring in insurance until Congress mandated a study on this matter as part of the Fair Access to Credit Transactions (FACT) Act (Section 215). Unfortunately, the agency charged with completing this study, the Federal Trade Commission, has chosen to use data for this analysis from an industry-sponsored study that cannot be independently verified for bias or accuracy. It is very likely, therefore, that the study will offer an unreliable description of insurance credit scoring and its alternatives.

[11] "Report to the 79th Legislature: Use of Credit Information by Insurers in Texas," Texas Department of Insurance, December 30, 2004; "Insurance-Based Credit Scores: Impact on Minority and Low Income Populations in Missouri," Missouri Department of Insurance, January 2004.

[12] Letter from Consumer Federation of America and NJ CURE to NAIC President Alessandro Iuppa regarding GEICO rating methods and underwriting guidelines, March 14, 2006.

tivities. There are other such organizations that also set pure premiums or do other activities that result in joint insurance company decisions. These include the National Council on Compensation Insurance (NCCI) and National Insurance Services Organization (NISS). Examples of ISO's many anticompetitive activities are attached.

Today the rate bureaus still produce joint price guidance for the large preponderance of the rate. The rating bureaus start with historic data for these costs and then actuarially manipulate the data (through processes such as "trending" and "loss development") to determine an estimate of the projected cost of claims and adjustment expenses in the future period when the costs they are calculating will be used in setting the rates for many insurers. Rate bureaus, of course, must bias their projections to the high side to be sure that the resulting rates or loss costs are high enough to cover the needs of the least efficient, worst underwriting insurer member or subscriber to the service.

Legal experts testifying before the House Judiciary Committee in 1993 concluded that, absent McCarran-Ferguson's antitrust exemption, manipulation of historic loss data to project losses into the future would be illegal (whereas the simple collection and distribution of historic data itself would be legal). This is why there are no similar rate bureaus in other industries. For instance, there is no CSO (Contractor Services Office) predicting the cost of labor and materials for construction of buildings in the construction trades for the next year (to which contractors could add a factor to cover their overhead and profit). The CSO participants would go to jail for such audacity.

Further, rate organizations like ISO file "multipliers" for insurers to convert the loss costs into final rates. The insurer merely has to tell ISO what overhead expense load and profit load they want and a multiplier will be filed. The loss cost times the multiplier is the rate the insurer will use. An insurer can, as ISO once did, use an average expense of higher cost insurers for the expense load if it so chooses plus the traditional ISO profit factor of 5 percent and replicate the old "bureau" rate quite readily.

It is clear that the rate bureaus [13] still have a significant anti-competitive influence on insurance prices in America.

- The rate bureaus guide pricing with their loss cost/multiplier methods.
- The rate bureaus manipulate historic data in ways that would not be legal absent the McCarran-Ferguson antitrust exemption.
- The rate bureaus also signal to the market that it is OK to raise rates. The periodic "hard" markets are a return to rate bureau pricing levels after falling below such pricing during the "soft" market phase.
- The rate bureaus signal other market activities, such as when it is time for a market to be abandoned and consumers left, possibly, with no insurance.

More recently, insurers have begun to utilize new third party organizations (like RMS and Fair Isaac) to provide information (often from "black boxes" beyond state insurance department regulatory reach) for key insurance pricing and underwriting decisions, which helps insurers to avoid scrutiny for their actions. These organizations are not regulated by the state insurance departments and have a huge impact on rates and underwriting decisions with no state oversight. Indeed RMS's action, since it is not a regulated entity, may be a violation of current antitrust laws.

4. Reverse Competition in Some Lines of Insurance

As indicated above, some lines of insurance, such as credit insurance (including mortgage life insurance), title insurance and forced placed insurance, suffer from "reverse competition." Reverse competition occurs when competition acts to drive prices up, not down. This happens when the entity that selects the insurer is not the ultimate consumer but a third party that receives some sort of kickback (in the form of commissions, below-cost services, affiliate income, sham reinsurance, *etc.*).

An example is credit insurance added to a car loan. The third-party selecting the insurer is the car dealer who is offered commissions for the deal. The dealer will often select the insurer with the biggest kickback, not with the lower rate. This causes the price of the insurance to rise and the consumer to pay higher rates.

Other examples of reverse competition occur in the title and mortgage guaranty lines, where the product is required by a third party and not the consumer paying

[13] By "rate bureaus" here I include the traditional bureaus (such as ISO) but also the new bureaus that have a significant impact on insurance pricing such as the catastrophe modelers (including RMS) and other non-regulated organizations that impact insurance pricing and other decisions across many insurers (credit scoring organizations like Fair Isaac are one example).

for the coverage. In these two cases, the insurer markets its product not to the consumer paying for the product, but to the third party who is in the position to steer the ultimate consumer to the insurer. This competition for the referrers of business drives up the cost of insurance—hence, reverse competition.

We know from the investigations and settlements by New York Attorney General Eliot Spitzer that even sophisticated buyers can suffer from bid rigging and other negative consequences of "reverse-competition." Even when unsophisticated consumers purchase insurance lines that don't typically have reverse competition, these buyers can suffer similar consequences if they do not shop carefully. Independent agents represent several insurance companies. At times, this can be helpful, but not always. If a buyer is not diligent, an agent could place the consumer into a higher priced insurer with a bigger commission rate for the agent. Unfortunately, this happens too often since regulators have not imposed suitability or lowest cost requirements on the agents.

5. Claims Problems

Many consumers face a variety of claims problems. Often, their only recourse is to retain an attorney, an option that is not affordable for consumers in many situations. For example, many Gulf Coast residents are in litigation over handling of homeowners claims by insurers after Hurricane Katrina. We have seen many reports from consumers of situations that appear to involve bad claims handling practices, particularly related to policy forms that appear ambiguous. [14]

Some insurers have also adopted practices that routinely "low-ball" claims offers through the use of computerized claims processing and other techniques that have sought to cut claims costs arbitrarily.

6. The Revolving Door Between Regulators and the Insurance Industry Results in Undue Industry Influence at the National Association of Insurance Commissioners

The NAIC recently celebrated its founding by asking former presidents of the Association to fete the organization. The list was astonishing for the number of ex-regulators who now work for the insurance industry:

2005: Diane Koken—currently Pennsylvania Commissioner

2004: Ernest Csiszar—moved in mid-term as NAIC President to lobby on behalf of the property-casualty insurers as President of the Property Casualty Insurers Association

2003: Mike Pickens—currently lobbies on behalf of insurers as a private attorney

2002: Terrie Vaughn—currently lobbies on behalf of life insurers as a Board Member of Principal Financial Group

2001: Kathleen Sebelius—currently Governor of Kansas

2000: George Nichols—currently works for New York Life

1998: Glenn Pomeroy—currently works and lobbies on behalf of General Electric Insurance Solutions

1996: Brian Atkinson—currently President of the Insurers Marketplace Standards Association, an organization controlled and supported by life insurers

1993: Steve Foster—currently works for Deloitte and Touche

1992: Bill McCartney—currently works and lobbies on behalf of USAA

The revolving door of regulators to industry and of industry to regulators is particularly troubling given the role of the NAIC in state insurance regulation. The NAIC plays a major role in guiding state insurance oversight, yet it is organized as a non-profit trade association of regulators and, consequently, lacks the public accountability of a government agency, like an insurance department. For example, it is not subject to Freedom of Information statutes. In addition, policy decisions are made at the NAIC by allowing each state one vote, not matter the population of the state. This means that the Commissioner of Insurance in South Dakota has equal influence as the California or New York regulator. The result is that regulators in states comprising a minority of the country's population can determine national policy for the entire country. This problem is exacerbated by the inappropriate industry influence resulting from the revolving door between regulators and industry.

[14] Reviews of calls to the Americans for Insurance Reform hotline are available at *www.insurancereform.org.*

Why Have Insurers Recently Embraced Federal Regulation (Again)?

The recent "conversion" of some insurers to the concept of Federal regulation is based solely on the notion that such regulation would be weaker. Insurers have, on occasion, sought Federal regulation when the states increased regulatory control and the Federal regulatory attitude was more laissez-faire. Thus, in the 1800s, the industry argued in favor of a Federal role before the Supreme Court in *Paul v. Virginia,* but the court ruled that the states controlled because insurance was intrastate commerce.

Later, in the 1943 SEUA case, the Court reversed itself, declaring that insurance was interstate commerce and that Federal antitrust and other laws applied to insurance. By this time, Franklin Roosevelt was in office and the Federal Government was a tougher regulator than were the states. The industry sought, and obtained, the McCarran-Ferguson Act. This law delegated exclusive authority for insurance regulation to the states, with no routine Congressional review. The Act also granted insurers a virtually unheard of exemption from antitrust laws, which allowed insurance companies to collude in setting rates and to pursue other anticompetitive practices without fear of Federal prosecution.

From 1943 until recently, the insurance industry has violently opposed any Federal role in insurance regulation. In 1980, insurers successfully lobbied to stop the Federal Trade Commission from investigating deceptive acts and practices of any kind in the insurance industry. They also convinced the White House that year to eliminate the Federal Insurance Administration's work on insurance matters other than flood insurance. Since that time, the industry has successfully scuttled any attempt to require insurers to comply with Federal antitrust laws and has even tried to avoid complying with Federal civil rights laws.

Notice that the insurance industry is very pragmatic in their selection of a preferred regulator. They always favor the least regulation. It is not surprising that, today, the industry would again seek a Federal role at a time they perceive little regulatory interest at the Federal level. But, rather than going for full Federal control, they have learned that there are ebbs and flows in regulatory oversight at the Federal and state levels, so they seek the ability to switch back and forth at will.

Further, the insurance industry has used the possibility of an increased Federal role to pressure NAIC and the states into gutting consumer protections over the last three or 4 years. Insurers have repeatedly warned states that the only way to preserve their control over insurance regulation is to weaken consumer protections.[15]

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[15] The clearest attempt to inappropriately pressure the NAIC occurred at their spring 2001 meeting in Nashville. There, speaking on behalf of the entire industry, Paul Mattera of Liberty Mutual Insurance Company told the NAIC that they were losing insurance companies every day to political support for the Federal option and that their huge effort in 2000 to deregulate and speed product approval was too little, too late. He called for an immediate step-up of deregulation and measurable "victories" of deregulation to stem the tide. In a July 9, 2001, Wall Street Journal article by Chris Oster, Mattera admitted his intent was to get a "headline or two to get people refocused." His remarks were so offensive that CFA's Bob Hunter went up to several top commissioners immediately afterward and said that Materra's speech was the most embarrassing thing he had witnessed in 40 years of attending NAIC meetings. He was particularly embarrassed since no commissioner challenged Mattera and many commissioners had almost begged the industry to grant them more time to deliver whatever the industry wanted.

Jane Bryant Quinn, in her speech to the NAIC on October 3, 2000, said: "Now the industry is pressing state regulators to be even more hands-off with the threat that otherwise they'll go to the feds." So other observers of the NAIC see this pressure as potentially damaging to consumers.

Larry Forrester, President of the National Association of Mutual Insurance Companies (NAMIC), wrote an article in the National Underwriter of June 4, 2000. In it he said, " . . . how long will Congress and our own industry watch and wait while our competitors continue to operate in a more uniform and less burdensome regulatory environment? Momentum for Federal regulation appears to be building in Washington and state officials should be as aware of it as any of the rest of us who have lobbyists in the nation's capital . . . NAIC's ideas for speed to market, complete with deadlines for action, are especially important. Congress and the industry will be watching closely . . . The long knives for state regulation are already out . . . "

In a press release entitled "Alliance Advocates Simplification of Personal Lines Regulation at NCOIL Meeting; Sees it as Key to Fighting Federal Control" dated March 2, 2001, John Lobert, Senior VP of the Alliance of American Insurers, said, "Absent prompt and rapid progress (in deregulation) . . . others in the financial services industry—including insurers—will aggressively pursue Federal regulation of our business . . . "

In the NAIC meeting of June 2006, Neil Alldredge of the National Association of Mutual Insurance Companies pointed out that "states are making progress with rate deregulation reforms. In the past 4 years, 16 states have enacted various price deregulation reforms . . . (but) change is not happening quickly enough . . . He concluded that the U.S. Congress is interested in insurance regulatory modernization and the insurance industry will continue to educate Congress

Continued

They have been assisted in this effort by a series of House hearings, which rather than focusing on the need for improved consumer protection have served as a platform for a few Representatives to issue ominous statements calling on the states to further deregulate insurance oversight, "or else."

This strategy of "whipsawing" state regulators to lower standards benefits all elements of the insurance industry, even those that do not support any Federal regulatory approach. Even if Congress does nothing, the threat of Federal intervention is enough to scare state regulators into acceding to insurer demands to weaken consumer protections.

Unfortunately for consumers, the strategy has already paid off, before the first insurance bill is ever marked up in Congress. In the last few years, the NAIC has moved suddenly to cut consumer protections adopted over a period of decades. The NAIC is terrified of Congressional action and sees the way to "save" state regulation is to gut consumer protections to placate insurance companies and encourage them to stay in the fold. This strategy of saving the village by burning it has made state regulation more, not less vulnerable to Federal takeover.

The NAIC has also failed to act in the face of a number of serious problems facing consumers in the insurance market.

NAIC Failures To Act

1. Failure to do anything about abuses in the small face life market. Instead, NAIC adopted an incomprehensible disclosure on premiums exceeding benefits, but did nothing on overcharges, multiple policies, or unfair sales practices.
2. Failure to do anything meaningful about unsuitable sales in any line of insurance. Suitability requirements still do not exist for life insurance sales even in the wake of the remarkable market conduct scandals of the late 1980s and early 1990s. A senior annuities protection model was finally adopted (after years of debate) that is so limited as to do nothing to protect consumers.
3. Failure to call for collection and public disclosure of market performance data after years of requests for regulators to enhance market data, as NAIC weakened consumer protections. How does one test whether a market is workably competitive without data on market shares by zip code and other tests?
4. Failure to call for repeal of the antitrust exemption in the McCarran-Ferguson Act as they push forward deregulation model bills.
5. Failure to do anything as an organization on the use of credit scoring for insurance purposes. In the absence of NAIC action, industry misinformation about credit scoring has dominated state legislative debates. NAIC's failure to analyze the issue and perform any studies on consumer impact, especially on lower income consumers and minorities, has been a remarkable dereliction of duty.
6. Failure to end use of occupation and education in underwriting and pricing of auto insurance.
7. Failure to address problems with risk selection. There has not even been a discussion of insurers' explosive use of underwriting and rating factors targeted at socio-economic characteristics: credit scoring, check writing, prior bodily injury coverage limits purchased by the applicant, prior insurer, prior non-standard insurer, not-at-fault claims, not to mention use of genetic information, where Congress has had to recently act to fill the regulatory void.
8. Failure to heed calls from consumer leaders to do something about contingency commissions for decades until Attorney General Spitzer finally acted.
9. Failure to do anything on single premium credit insurance abuses.
10. Failure to take recent steps on redlining or insurance availability or affordability. Many states no longer even look at these issues, 30 years after the Federal Government issued studies documenting the abusive practices of insurers in this regard. Yet, ongoing lawsuits continue to reveal that redlining practices harm the most vulnerable consumers.
11. Failure to take meaningful action on conflict of interest restrictions even after Ernie Csiszar left his post as South Carolina regulator and President of the NAIC in September 2004 to become President of the Property Casualty Insurers Association of America after negotiating deregulation provisions in the SMART Act desired by PCIAA members.

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about the slow pace of change in the states." Minutes of the NAIC/Industry Liaison Committee, June 10, 2006.

NAIC Rollbacks of Consumer Protections

1. The NAIC pushed through small business property-casualty deregulation, without doing anything to reflect consumer concerns (indeed, even refusing to tell consumer groups why they rejected their specific proposals) or to upgrade "back-end" market conduct quality, despite promises to do so. As a result, many states adopted the approach and have rolled back their regulatory protections for small businesses.
2. States are rolling back consumer protections in auto insurance as well. New Jersey, Texas, Louisiana, and New Hampshire have done so in the last 2 years.
3. NAIC has terminated free access for consumers to the annual statements of insurance companies at a time when the need for enhanced disclosure is needed if price regulation is to be reduced.

Can Competition Alone Guarantee a Fair, Competitive Insurance Market?

Consumers, who over the last 30 years have been the victims of vanishing premiums, churning, race-based pricing, creaming, and consumer credit insurance policies that pay pennies in claims per dollar in premium, are not clamoring for such policies to be brought to market with even less regulatory oversight than in the past. The fact that "speed-to-market" has been identified as a vital issue in modernizing insurance regulation demonstrates that some policymakers have bought into insurers' claims that less regulation benefits consumers. We disagree. We think smarter, more efficient regulation benefits both consumers and insurers and leads to more beneficial competition. Mindless deregulation, on the other hand, will harm consumers.

The need for better regulation that benefits both consumers and insurers is being exploited by some in the insurance industry to eliminate the most effective aspects of state insurance regulation such as rate regulation, in favor of a model based on the premise that competition alone will protect consumers.[16] We question the entire foundation behind the assumption that virtually no front-end regulation of insurance rates and terms coupled with more back-end (market conduct) regulation is better for consumers. The track record of market conduct regulation has been extremely poor. As noted above, insurance regulators rarely are the first to identify major problems in the marketplace.

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[16] If America moves to a "competitive" model, certain steps must first be taken to ensure "true competition" and prevent consumer harm. First, insurance lines must be assessed to determine whether a competitive model, *e.g.*, the alleviation of rate regulation, is even appropriate. This assessment must have as its focus how the market works for consumers. For example, states cannot do away with rate regulation of consumer credit insurance and other types of insurance subject to reverse competition. The need for relative cost information and the complexity of the line/policy are factors that must be considered.

If certain lines are identified as appropriate for a "competitive" system, before such a system can be implemented, the following must be in place:

* Policies must be transparent: Disclosure, policy form and other laws must create transparent policies. Consumers must be able to comprehend the policy's value, coverage, actual costs, including commissions and fees. If consumers cannot adequately compare actual costs and value, and if consumers are not given the best rate for which they qualify, there can be no true competition.

* Policies should be standardized to promote comparison-shopping.

* Antitrust laws must apply.

* Anti-rebate, anti-group and other anti-competitive state laws must be repealed.

* Strong market conduct and enforcement rules must be in place with adequate penalties to serve as an incentive to compete fairly and honestly.

* Consumers must be able to hold companies legally accountable through strong private remedies for losses suffered as a result of company wrongdoing.

* Consumers must have knowledge of and control over flow and access of data about their insurance history through strong privacy rules.

* There must be an independent consumer advocate to review and assess the market, assure the public that the market is workably competitive, and determine if policies are transparent.

Safeguards to protect against competition based solely on risk selection must also be in place to prevent redlining and other problems, particularly with policies that are subject to either a public or private mandate. If a competitive system is implemented, the market must be tested on a regular basis to make sure that the system is working and to identify any market dislocations. Standby rate regulation should be available in the event the "competitive model" becomes dysfunctional.

If the industry will not agree to disclosing actual costs, including all fees and commissions, ensuring transparency of policies, strong market conduct rules and enforcement then it is not advocating true competition, only deregulation.

Given this track record, market conduct standards and examinations by regulators must be dramatically improved to enable regulators to become the first to identify and fix problems in the marketplace and to address market conduct problems on a national basis. From an efficiency and consumer protection perspective, it makes no sense to lessen efforts to prevent the introduction of unfair and inappropriate policies in the marketplace. It takes far less effort to prevent an inappropriate insurance policy or market practice from being introduced than to examine the practice, stop a company from doing it and provide proper restitution to consumers after the fact.

The unique nature of insurance policies and insurance companies requires more extensive front-end regulation than other consumer commodities. And while insurance markets can be structured to promote beneficial price competition, deregulation does not lead to, let alone guarantee, such beneficial price competition.

Front-end regulation should be designed to prevent market conduct problems from occurring instead of inviting those problems to occur. It should also promote beneficial competition, such as price competition and loss mitigation efforts, and deter destructive competition, such as selection competition, and unfair sales and claims settlement practices. Simply stated, strong, smart, efficient and consistent front-end regulation is critical for meaningful consumer protection and absolutely necessary to any meaningful modernization of insurance regulation.

Is Regulation Incompatible With Competition?

The insurance industry promotes a myth: that regulation and competition are incompatible. This is demonstrably untrue. Regulation and competition both seek the same goal: the lowest possible price consistent with a reasonable return for the seller. There is no reason that these systems cannot coexist and even compliment each other.

The proof that competition and regulation can work together to benefit consumers and the industry is the manner in which California regulates auto insurance under Proposition 103. Indeed, that was the theory of the drafters (including CFA's Bob Hunter) of Proposition 103. Before Proposition 103, Californians had experienced significant price increases under a system of "open competition" of the sort the insurers now seek at the Federal level. (No regulation of price is permitted but rate collusion by rating bureaus is allowed, while consumers receive very little help in getting information.) Proposition 103 sought to maximize competition by eliminating the state antitrust exemption, laws that forbade agents to compete, laws that prohibited buying groups from forming, and so on. It also imposed the best system of prior approval of insurance rates and forms in the nation, with very clear rules on how rates would be judged.

As our in-depth study of regulation by the states revealed,[17] California's regulatory transformation—to rely on both maximum regulation and competition—has produced remarkable results for auto insurance consumers and for the insurance companies doing business there. The study reported that insurers realized very nice profits, above the national average, while consumers saw the average price for auto insurance drop from $747.97 in 1989, the year Proposition 103 was implemented, to $717.98 in 1998. Meanwhile, the average premium rose nationally from $551.95 in 1989 to $704.32 in 1998. California's rank dropped from the third costliest state to the 20th.

I can update this information through 2003.[18] As of 2003, the average annual premium in California was $821.11 (20th in the nation) versus $820.91 for the nation. So, from the time California went from reliance simply on competition as insurers envisioned it to full competition and regulation, the average auto rate rose by 9.8 percent while the national average rose by 48.7 percent. In 1989, California consumers were paying 36 percent more that the national average, while today they pay virtually the national average price. A powerhouse result!

How Can Uniformity Be Achieved Without Loss of Consumer Protections?

CFA would endorse a more uniform national or multi-state approach if certain rigorous conditions were met. The attached fact sheet, Consumer Principles and Standards for Insurance Regulation, provides detailed standards that regulators should meet to properly protect consumers, whether at the state, multi-state or national level. It should be noted that none of the proposals offered by insurers or on

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[17] "Why Not the Best? The Most Effective Auto Insurance Regulation in the Nation," June 6, 2000; *www.consumerfed.org.*

[18] State Average Expenditures and Premiums for Personal Automobile Insurance in 2003, NAIC, July 2005.

behalf of insurers (such as the Oxley-Baker “SMART” proposal) come close to meeting these standards.

One obvious vehicle for multi-state enforcement of insurance standards is the NAIC. The NAIC Commission of the Interstate Insurance Product Regulation Compact began operation with a small staff on June 13th of this year. We have favored empowering the NAIC to implement such a multi-state approach only if the NAIC’s decisionmaking procedures are overhauled to make it a more transparent, accountable body with meaningful regulatory powers. These steps would include public access to insurer filings during the review process and formal, funded consumer participation. To date, regulators have refused to take these steps. Moreover, the Commission will be unlikely to carry out its role as a truly independent regulator due to inadequate funding. The Commission will be receiving and reviewing life, annuity and long term care filings for at least 27 states, but its current budget only allows for a total staff of three people. As stated above, recent NAIC failures demonstrate that it is not an impartial regulatory body that can be counted on to adequately consider consumer needs.

Because of its historical domination by the insurance industry, consumer organizations are extremely skeptical about its ability to confer national treatment in a fair and democratic way. It is essential that any Federal legislation to empower the NAIC include standards to prevent undue industry influence and ensure the NAIC can operate as an effective regulatory entity, including:

- Democratic processes/accountability to the public, which must include: notice and comment rulemaking; on the record voting; accurate minutes; rules against *ex-parte* communication; public meeting/disclosure/sunshine rules/FOIA applicability.
- A decisionmaking process subject to an excellent Administrative Procedures Act.
- Strong conflict of interest and revolving door statutes similar to those of the Federal Government to prevent undue insurance industry influence. If decisionmaking members of the NAIC have connections, past or present, to certain companies, the process will not be perceived as fair.
- Independent funding. The NAIC cannot serve as a regulatory entity if it relies on the industry for its funding. The bill should establish a system of state funding to the NAIC at a set percentage of premium so that all states and insured entities equally fund the NAIC.
- National Independent Advocate. To offset industry domination, an independent, national, public insurance counsel/ombudsman with necessary funding is needed. Consumers must be adequately represented in the process for the process to be accountable and credible.

Regulation by Domiciliary States Will Lead to Unacceptably Weak Standards

We oppose allowing a domiciliary state to essentially act as a national regulator by allowing domiciled companies to comply only with that state’s standards. This approach has several potential problems, including the following:

- It promotes forum shopping. Companies would move from state to state to secure regulation from the state that has the least capacity to regulate, provoking a “race to the bottom.”
- The state of domicile is often under the greatest political and economic pressure not to act to end harmful business practices by a powerful in-state company.
- The resources of states to properly regulate insurance vary widely.
- It is antithetical to states’ rights to apply laws from other states to any business operating within their borders. If such a move is made, however, it is imperative that consumers have a national, independent advocate.
- It promotes a lack of consistency in regulation because companies could change domiciliary state status.
- Residents of one state cannot be adequately represented by the legislature/executive of another. If a resident’s state consumer protections did not apply, the resident would be subject to laws of a state in which they have no representation. How can a consumer living in Colorado influence decisions made in Connecticut?
- Rather than focusing on protecting consumers, this system would change the focus to protecting itself and its regulatory turf, as has happened in the bank regulatory system. State and Federal banking regulators have competed to lower their consumer protections to lure banks to their system.

- We would be particularly concerned with proposals to give exclusive control of market conduct exams to a domiciliary state. Unscheduled exams by a state are very important for that state's ability to protect its consumers from abuse. States must retain the ability to act quickly based on complaints or other information.

"One-Stop" Policy Approval Must Meet High Standards

Allowing insurers to get approval for their products from a single, unaccountable, non-state regulatory entity would also lead to extremely weak protections unless several conditions are met:

- An entity, such as the NAIC's Coordinated Advertising, Rate and Form Review Authority (CARFRA), that is not subject to authorizing legislation, due process standards, public accountability, prohibitions on *ex-parte* communications, and similar standards should not have the authority to determine which lines would be subject to a one-stop approval process or develop national standards. It also must have funding through the states, not directly from insurers. Independent funding ensures that the regulatory entity is not subject to unfair and detrimental industry influence.
- Any standards that apply must be high and improve the ability of consumers to understand policies and compare on the basis of price. Consumers do not want "speed-to-market" for bad policies.
- Any entity that serves as national standard setter, reviewer and/or approver needs Federal authorizing legislation. An "interstate compact" or "memorandum of understanding" is unworkable and unaccountable.
- Giving the regulated insurer the option to choose which entity regulates it is an invitation to a race to the bottom for regulatory standards.
- Standardization of forms by line has the potential to assist consumers if done in such a way to enhance understanding of terms, benefits, limitations and actual costs of policies.
- Public/consumer input is essential if the entity makes decisions that ultimately affect information provided to and rates charged consumers.
- We support the concept of an electronic central filing repository, but the public must have access to it.
- To retain oversight of policies and rates affecting their residents, states must have the ability to reject decisions of the entity.
- Any national system must include a national, externally funded consumer-public advocate/counsel to represent consumers in standard setting, development of forms, rate approval, *etc.*

Current Federal Proposals

Given the extremely sorry state of state regulation, it is hard to believe that a Federal bill could be crafted that would make matters worse. Yet, insurers have managed to do it—not once, but twice! Their bills not only don't provide the basic standards of consumer protection cited above, they would undermine the low standards of consumer protection now extant in many states. For example, several trade associations have drafted legislation that would create an "optional Federal charter" for insurance regulation, patterned on the nation's bifurcated Federal/state bank chartering structure. In response, Senator Ernest Hollings introduced legislation before he retired that would establish Federal minimum standards for insurance regulation and repeal insurers' antitrust exemption under the McCarran-Ferguson Act. Senator Hollings' goal was to prevent competition between state and Federal regulators to lower standards. Most recently, Representatives Michael Oxley and Richard Baker have circulated a discussion draft entitled the "State Modernization and Regulatory Transparency (SMART) Act." We will comment separately on each.

Optional Federal Insurance Charter

The bills that have been drafted by trade associations like the American Bankers Association and the American Council of Life Insurers would create a Federal regulator that would have little, if any, authority to regulate price or product, regardless of how non-competitive the market for a particular line of insurance might be. They also offer little improvement in consumer information or protection systems to address the major problems cited above. Insurers would be able to choose whether to be regulated by this Federal body or by state regulators.

Consumer organizations strongly oppose an optional Federal charter that allows the regulated company, at its sole discretion, to pick its regulator. This is a prescription for regulatory arbitrage that can only undermine needed consumer protections.

Indeed the drafters of such proposals have openly stated that this is their goal. If elements of the insurance industry truly want to obtain uniformity of regulation, "speed to market" and other advantages through a Federal regulator, let them propose a Federal approach that does not allow insurers to run back to the states when regulation gets tougher. We could all debate the merits of that approach.

CFA and the entire consumer community stand ready to fight optional charters with all the strength we can muster.

The Insurance Consumer Protection Act of 2003, S. 1373

Only one recent bill considers the consumer perspective in its design, adopting many of the consumer protection standards cited in this testimony. That is S. 1373 introduced by Senator Hollings. The bill would adopt a unitary Federal regulatory system under which all interstate insurers would be regulated. Intrastate insurers would continue to be regulated by the states.

The bill's regulatory structure requires Federal prior approval of prices to protect consumers, including some of the approval procedures (such as hearing requirements when prices change significantly) being used so effectively in California. It requires annual market conduct exams. It creates an office of consumer protection. It enhances competition by removing the antitrust protection insurers hide behind in ratemaking. It improves consumer information and creates a system of consumer feedback.

If Federal regulation is to be considered, S. 1373 should be the baseline for any debate on the subject.

SMART Act

Rather than increase insurance consumer protections for individuals and small businesses while spurring states to increase the uniformity of insurance regulation, this sweeping proposal would override important state consumer protection laws, sanction anticompetitive practices by insurance companies and incite state regulators into a competition to further weaken insurance oversight. It is quite simply one of the most grievously flawed and one-sided pieces of legislation that we have ever seen, with absolutely no protections for consumers. The consumers who will be harmed by it are our nation's most vulnerable: the oldest, the poorest and the sickest.

For example, the discussion draft would preempt state regulation of insurance rates. This would leave millions of consumers vulnerable to price gouging, as well as abusive and discriminatory insurance classification practices. It would also encourage a return to insurance redlining, as deregulation of prices would include the lifting of state controls on territorial line drawing. States would also be helpless to stop the misuse of risk classification information, such as credit scores, territorial data and the details of consumers' prior insurance history, for pricing purposes. The draft bill goes so far as to deregulate cartel-like organizations such as the Insurance Services Office and the National Council on Compensation Insurance, while leaving the Federal antitrust exemption fully intact.

What the draft does not do is as revealing as what it does require. It does not create a Federal office to represent consumer interests, although the draft creates two positions to represent insurer interests. It takes no steps to spur increased competition in the insurance industry, such as providing assistance or information to the millions of consumers who find it extremely difficult to comparison shop for this complex and expensive product, or eliminating the antitrust exemption that insurers currently enjoy under the McCarran-Ferguson Act. Insurers are not required to meet community reinvestment requirements, as banks are, to guarantee that insurance is available in underserved communities. Nothing is done to prevent insurers from using inappropriate information, such as credit scores or a person's income, to develop insurance rates.

CFA supports the goals outlined in several sections of this draft. As stated above, we are not opposed to increasing uniformity in insurance regulation. Unfortunately, however, in almost every circumstance in which the draft attempts to ensure uniformity, it chooses the weakest consumer protection approach possible. (For more details on CFA's concerns with this draft, please see the attached letter to House Financial Services leaders dated September 9, 2004.)

H.R. 5637—Non-admitted Insurance/Reinsurance Regulation

This sharply scaled-back version of the SMART Act would only apply to surplus (non-admitted insurance) lines of insurance and reinsurance. It would provide for a method of collecting state premium taxes for surplus lines and allocating this income to the states. It would give deference to the regulations of the home state of the entity purchasing the insurance policy and in regulating surplus lines brokers. Further, the bill would adopt the NAIC's non-admitted insurance model act for eligi-

bility requirements for surplus lines carriers on a national basis, preempting other state laws. It allows large buyers of insurance to get surplus lines coverage without having to show, as most states require today, that a search of the licensed market was made and no coverage was found.

It would give deference to the home state of the ceding insurer for regulation, prohibiting any state from enforcing extra-territorial authority of its laws. Solvency regulation would be done by the state of domicile of the reinsurer.

CFA opposes this bill because it is based upon many faulty assumptions. First, it assumes that large buyers of insurance are sophisticated enough that they don't need protections that would normally be provided in an insurance transaction. Of course, the investigations and settlements implemented by New York Attorney General Eliot Spitzer mentioned above refute this assumption.

Second, the bill assumes that the domiciled state of an insurer is best for solvency regulation. This is not true. When CFA's Bob Hunter was Insurance Commissioner of Texas, he had to investigate an insolvent insurer in another state because the commissioner of that state refused to do so. Several directors of that insurer were former Governors and insurance commissioners of the domiciliary state. We list above several other objections to giving deference to the state of domicile, which are also relevant.

Third, the bill raises concerns about great regulatory confusion and ineptitude that would likely result when the state of the insured entity regulates all parts of that entity's insurance transaction. What does Iowa, for instance, know about the hurricane risk/claims of the operations of an Iowa business on the Gulf Coast or how no-fault or other unique state laws should apply to a given claim situation?

Fourth, the bill would allow consumers to be harmed in the event that a surplus lines insurer becomes insolvent. This is because the guaranty associations in all states do not cover claims for surplus lines insurers. This may be no problem for the defunct policyholder and the defunct insurer, but it sure is a problem for the people that the policyholder may have injured.

Federal Insurance Reform That Insurers Won't Discuss: Amending the McCarran-Ferguson Act To Provide Federal Oversight of and, Perhaps, Minimum Standards for Efficient and Effective Regulation

Insurers want competition alone to determine rates, they say. How about a simple repeal of the antitrust exemption in the McCarran-Ferguson Act to test their desire to compete under the same rules as normal American businesses?

Another amendment to the McCarran Act we would suggest is to do what should have been done at the beginning of the delegation of authority to the states: have the FTC and other Federal agencies perform scheduled oversight of the states' regulatory performance and propose minimum standards for effective and efficient consumer protection. The Hollings bill or relevant provisions of Proposition 103 in California might be the basis for such minimum standards.

Conclusion

CFA looks forward to working with the Committee to strengthen consumer protection for insurance consumers, Mr. Chairman. I will be happy to respond to questions at the appropriate time.

Attachment 1

Consumer Principles and Standards for Insurance Regulation

1. Consumers should have access to timely and meaningful information about the costs, terms, risks and benefits of insurance policies.

- Meaningful disclosure prior to sale tailored for particular policies and written at the education level of the average consumer sufficient to educate and enable consumers to assess a particular policy and its value should be required for all insurance; it should be standardized by line to facilitate comparison shopping; it should include comparative prices, terms, conditions, limitations, exclusions, loss ratio expected, commissions/fees and information on seller (service and solvency); it should address non-English speaking or ESL populations.
- Insurance departments should identify, based on inquiries and market conduct exams, populations that may need directed education efforts, *e.g.*, seniors, low-income, low education.
- Disclosure should be made appropriate for medium in which product is sold, *e.g.*, in person, by telephone, on-line.

- Loss ratios should be disclosed in such a way that consumers can compare them for similar policies in the market, *e.g.*, a scale based on insurer filings developed by insurance regulators or an independent third party.
- Non-term life insurance policies, *e.g.*, those that build cash values, should include rate of return disclosure. This would provide consumers with a tool, analogous to the APR required in loan contracts, with which they could compare competing cash value policies. It would also help them in deciding whether to buy cash value policies.
- A free look period should be required; with meaningful state guidelines to assess the appropriateness of a policy and value based on standards the state creates from data for similar policies.
- Comparative data on insurers' complaint records, length of time to settle claims by size of claim, solvency information, and coverage ratings (*e.g.*, policies should be ranked based on actuarial value so a consumer knows if comparing apples to apples) should be available to the public.
- Significant changes at renewal must be clearly presented as warnings to consumers, *e.g.*, changes in deductibles for wind loss.
- Information on claims policy and filing process should be readily available to all consumers and included in policy information.
- Sellers should determine and consumers should be informed of whether insurance coverage replaces or supplements already existing coverage to protect against over-insuring, *e.g.*, life and credit.
- Consumer Bill of Rights, tailored for each line, should accompany every policy.
- Consumer feedback to the insurance department should be sought after every transaction (*e.g.*, after policy sale, renewal, termination, claim denial). The insurer should give the consumer notice of feedback procedure at the end of the transaction, *e.g.*, form on-line or toll-free telephone number.

2. *Insurance policies should be designed to promote competition, facilitate comparison-shopping and provide meaningful and needed protection against loss.*
   - Disclosure requirements above apply here as well and should be included in the design of policy and in the policy form approval process.
   - Policies must be transparent and standardized so that true price competition can prevail. Components of the insurance policy must be clear to the consumer, *e.g.*, the actual current and future cost, including commissions and penalties.
   - Suitability or appropriateness rules should be in place and strictly enforced, particularly for investment/cash value policies. Companies must have clear standards for determining suitability and compliance mechanism. For example, sellers of variable life insurance are required to find that the sales that their representatives make are suitable for the buyers. Such a requirement should apply to all life insurance policies, particularly when replacement of a policy is at issue.
   - "Junk" policies, including those that do not meet a minimum loss ratio, should be identified and prohibited. Low-value policies should be clearly identified and subject to a set of strictly enforced standards that ensure minimum value for consumers.
   - Where policies are subject to reverse competition, special protections are needed against tie-ins, overpricing, *e.g.*, action to limit credit insurance rates.
3. *All consumers should have access to adequate coverage and not be subject to unfair discrimination.*
   - Where coverage is mandated by the state or required as part of another transaction/purchase by the private market (*e.g.*, mortgage), regulatory intervention is appropriate to assure reasonable affordability and guarantee availability.
   - Market reforms in the area of health insurance should include guaranteed issue and community rating and, where needed, subsidies to assure health care is affordable for all.
   - Information sufficient to allow public determination of unfair discrimination must be available. Geo-code data, rating classifications and underwriting guidelines, for example, should be reported to regulatory authorities for review and made public.
   - Regulatory entities should conduct ongoing, aggressive market conduct reviews to assess whether unfair discrimination is present and to punish and remedy it if found, *e.g.*, redlining reviews (analysis of market shares by census tracts or zip codes, analysis of questionable rating criteria such as credit rating), re-

views of pricing methods, and reviews of all forms of underwriting instructions, including oral instructions to producers.

- Insurance companies should be required to invest in communities and market and sell policies to prevent or remedy availability problems in communities.
- Clear anti-discrimination standards must be enforced so that underwriting and pricing are not unfairly discriminatory. Prohibited criteria should include race, national origin, gender, marital status, sexual preference, income, language, religion, credit history, domestic violence, and, as feasible, age and disabilities. Underwriting and rating classes should be demonstrably related to risk and backed by a public, credible statistical analysis that proves the risk-related result.

4. *All consumers should reap the benefits of technological changes in the marketplace that decrease prices and promote efficiency and convenience.*
   - Rules should be in place to protect against redlining and other forms of unfair discrimination via certain technologies, *e.g.*, if companies only offer better rates, *etc.* online.
   - Regulators should take steps to certify that online sellers of insurance are genuine, licensed entities and tailor consumer protection, UTPA, *etc.* to the technology to ensure consumers are protected to the same degree regardless of how and where they purchase policies.
   - Regulators should develop rules/principles for e-commerce (or use those developed for other financial firms if appropriate and applicable.)
   - In order to keep pace with changes and determine whether any specific regulatory action is needed, regulators should assess whether and to what extent technological changes are decreasing costs and what, if any, harm or benefits accrue to consumers.
   - A regulatory entity, on its own or through delegation to an independent third party, should become the portal through which consumers go to find acceptable sites on the web. The standards for linking to acceptable insurer sites via the entity and the records of the insurers should be public; the sites should be verified/reviewed frequently and the data from the reviews also made public.
5. *Consumers should have control over whether their personal information is shared with affiliates or third parties.*
   - Personal financial information should not be disclosed for purposes other than the one for which it is given unless the consumer provides prior written or other form of verifiable consent.
   - Consumers should have access to the information held by the insurance company to make sure it is timely, accurate and complete. They should be periodically notified how they can obtain such information and how to correct errors.
   - Consumers should not be denied policies or services because they refuse to share information (unless information is needed to complete the transaction).
   - Consumers should have meaningful and timely notice of the company's privacy policy and their rights and how the company plans to use, collect and or disclose information about the consumer.
   - Insurance companies should have a clear set of standards for maintaining the security of information and have methods to ensure compliance.
   - Health information is particularly sensitive and, in addition to a strong opt-in, requires particularly tight control and use only by persons who need to see the information for the purpose for which the consumer has agreed to the sharing of the data.
   - Protections should not be denied to beneficiaries and claimants because a policy is purchased by a commercial entity rather than by an individual (*e.g.*, a worker should get privacy protection under workers' compensation).
6. *Consumers should have access to a meaningful redress mechanism when they suffer losses from fraud, deceptive practices or other violations; wrongdoers should be held accountable directly to consumers.*
   - Aggrieved consumers must have the ability to hold insurers directly accountable for losses suffered due to their actions. UTPAs should provide private cause of action.
   - Alternative Dispute Resolution clauses should be permitted and enforceable in consumer insurance contracts only if the ADR process is: 1) contractually mandated with non-binding results, 2) at the option of the insured/beneficiary with

binding results, or 3) at the option of the insured/beneficiary with nonbinding results.

- Bad faith causes of action must be available to consumers.
- When regulators engage in settlements on behalf of consumers, there should be an external, consumer advisory committee or other mechanism to assess fairness of settlement and any redress mechanism developed should be an independent, fair and neutral decisionmaker.
- Private attorney general provisions should be included in insurance laws.
- There should be an independent agency that has as its mission to investigate and enforce deceptive and fraudulent practices by insurers, *e.g.*, the reauthorization of FTC.

7. *Consumers should enjoy a regulatory structure that is accountable to the public, promotes competition, remedies market failures and abusive practices, preserves the financial soundness of the industry and protects policyholders' funds, and is responsive to the needs of consumers.*

- Insurance regulators must have a clear mission statement that includes as a primary goal the protection of consumers:
- The mission statement must declare basic fundamentals by line of insurance (such as whether the state relies on rate regulation or competition for pricing). Whichever approach is used, the statement must explain how it is accomplished. For instance, if competition is used, the state must post the review of competition (*e.g.*, market shares, concentration by zone, *etc.*) to show that the market for the line is workably competitive, apply anti-trust laws, allow groups to form for the sole purpose of buying insurance, allow rebates so agents will compete, assure that price information is available from an independent source, *etc.* If regulation is used, the process must be described, including access to proposed rates and other proposals for the public, intervention opportunities, *etc.*
- Consumer bills of rights should be crafted for each line of insurance and consumers should have easily accessible information about their rights.
- Regulators should focus on online monitoring and certification to protect against fraudulent companies.
- A department or division within the regulatory body should be established for education and outreach to consumers, including providing:
    - Interactive websites to collect from and disseminate information to consumers, including information about complaints, complaint ratios and consumer rights with regard to policies and claims.
    - Access to information sources should be user friendly.
    - Counseling services to assist consumers, *e.g.,* with health insurance purchases, claims, *etc.* where needed should be established.
- Consumers should have access to a national, publicly available data base on complaints against companies/sellers, *i.e.,* the NAIC data base. (NAIC is implementing this.)
- To promote efficiency, centralized electronic filing and use of centralized filing data for information on rates for organizations making rate information available to consumers, *e.g.,* help develop the information brokering business.
- Regulatory system should be subject to sunshine laws that require all regulatory actions to take place in public unless clearly warranted and specified criteria apply. Any insurer claim of trade secret status of data supplied to the regulatory entity must be subject to judicial review with the burden of proof on the insurer.
- Strong conflict of interest, code of ethics and anti-revolving door statutes are essential to protect the public.
- Election of insurance commissioners must be accompanied by a prohibition against industry financial support in such elections.
- Adequate and enforceable standards for training and education of sellers should be in place.
- The regulatory role should in no way, directly or indirectly, be delegated to the industry or its organizations.
- The guaranty fund system should be prefunded, national fund that protects policyholders against loss due to insolvency. It is recognized that a phase-in program is essential to implement this recommendation.

- Solvency regulation/investment rules should promote a safe and sound insurance system and protect policyholder funds, *e.g.*, providing a rapid response to insolvency to protect against loss of assets/value.
- Laws and regulations should be up to date with and applicable to e-commerce.
- Antitrust laws should apply to the industry.
- A priority for insurance regulators should be to coordinate with other financial regulators to ensure consumer protection laws are in place and adequately enforced regardless of corporate structure or ownership of insurance entity. Insurance regulators should err on side of providing consumer protection even if regulatory jurisdiction is at issue. This should be stated mission/goal of recent changes brought about by GLB law.
  - Obtain information/complaints about insurance sellers from other agencies and include in data bases.
- A national system of "Consumer Alerts" should be established by the regulators, *e.g.,* companies directed to inform consumers of significant trends of abuse such as race-based rates or life insurance churning.
- Market conduct exams should have standards that ensure compliance with consumer protection laws and be responsive to consumer complaints; exam standards should include agent licensing, training and sales/replacement activity; companies should be held responsible for training agents and monitoring agents with ultimate review/authority with the regulator. Market conduct standards should be part of an accreditation process.
- The regulatory structure must ensure accountability to the public it serves. For example, if consumers in state X have been harmed by an entity that is regulated by state Y, consumers would not be able to hold their regulators/legislators accountable to their needs and interests. To help ensure accountability, a national consumer advocate office with the ability to represent consumers before each insurance department is needed when national approaches to insurance regulation or "one-stop" approval processes are implemented.
- Insurance regulator should have standards in place to ensure mergers and acquisitions by insurance companies of other insurers or financial firms, or changes in the status of insurance companies (*e.g.*, demutualization, non-profit to for-profit), meet the needs of consumers and communities.
- Penalties for violations must be updated to ensure they serve as incentives against violating consumer protections and should be indexed to inflation.

8. Consumers should be adequately represented in the regulatory process.

- Consumers should have representation before regulatory entities that is independent, external to regulatory structure and should be empowered to represent consumers before any administrative or legislative bodies. To the extent that there is national treatment of companies, a national partnership, or "one-stop" approval, there must be a national consumer advocate's office created to represent the consumers of all states before the national treatment state, the one-stop state or any other approving entity.
- Insurance departments should support public counsel or other external, independent consumer representation mechanisms before legislative, regulatory and NAIC bodies.
- Regulatory entities should have a well-established structure for ongoing dialog with and meaningful input from consumers in the state, *e.g.,* a consumer advisory committee. This is particularly true to ensure that the needs of certain populations in the state and the needs of changing technology are met.

Attachment 2

CFA Consumer Federation of America

September 9, 2004

The Honorable Michael G. Oxley
Chair, Financial Services Committee
United State House of Representatives
Washington, DC 20515

The Honorable Barney Frank
Ranking Member, Financial Services Committee
United State House of Representatives
Washington, DC 20515

The Honorable Richard H. Baker
Chair, Subcommittee on Capital
Capital
Markets, Insurance and Government
Sponsored Enterprises
United State House of Representatives
Washington, DC 20515

The Honorable Paul E. Kanjorski
Ranking Member, Subcommittee on

Markets, Insurance and Government
Sponsored Enterprises
United State House of Representatives
Washington, DC 20515

Re: "State Modernization and Regulatory Transparency Act" Draft Will Harm Consumers, Undermine Competition and Gut Insurance Regulation

Dear Representatives Oxley, Frank, Baker and Kanjorski:

Few issues that the Financial Services Committee will examine this year are as important to consumers as the dramatic restructuring of insurance regulation proposed in the discussion draft of the "State Modernization and Regulatory Transparency Act" (SMART). Insurance has become a fundamental and increasingly expensive commodity that Americans must purchase in order to own a home, drive a car or start a small business. Much needs to be done to broaden consumer protections and improve the current state-based approach to the regulation of insurance.

Rather than increase insurance consumer protections for individuals and small businesses while spurring states to increase the uniformity of insurance regulation, this sweeping proposal would override important state consumer protection laws, sanction anticompetitive practices by insurance companies and incite state regulators into a "race to the bottom" to further weaken insurance oversight. It is quite simply one of the most grievously flawed and one-sided pieces of legislation that we have ever seen; a veritable "wish list" of items requested by insurers with absolutely no protections offered for consumers. The consumers who will be harmed by it are our nation's most vulnerable: the oldest, the poorest and the sickest.

For example, the discussion draft would preempt state regulation of insurance rates. This would leave millions of consumers vulnerable to price gouging, as well as abusive and discriminatory insurance classification practices. It would also encourage a return to insurance redlining, as deregulation of prices would include the lifting of state controls on territorial line drawing. States would also be helpless to stop the misuse of risk classification information, such as credit scores, territorial data and the details of consumers' prior insurance history, for pricing purposes.

What the draft does not do is as revealing as what is does require. It does not create a federal office to represent consumer interests, although the draft creates two positions to represent insurer interests in Title XV. It takes no steps to spur increased competition in the insurance industry, such as providing assistance to the millions of consumers who find it extremely difficult to comparison shop for this complex and expensive product, or eliminating the antitrust exemption that insurers currently enjoy under the McCarran-Ferguson Act. Insurers are not required to meet community reinvestment requirements, as banks are, to guarantee that insurance is available in underserved communities. Nothing is done to prevent insurers from using inappropriate information, such as credit scores or a person's income, to develop insurance rates.

Since consumers foot the bill when regulatory inefficiencies exist, CFA is certainly not opposed to increasing uniformity in state insurance regulation -- as long as this involves the implementation of high consumer protection standards. In fact, CFA supports the goals outlined in several sections of this draft. Unfortunately, however, in almost every circumstance in which the draft attempts to ensure uniformity, it chooses the weakest consumer protection approach possible.

Our specific concerns with the draft include the following:

1. **State rate regulation would be preempted**. Most states review rate increases prior to their implementation today. Title XVI of the draft would eliminate this protection. For most lines of insurance, the draft would eliminate rate regulation after two years. During the two-year phase-in period, rates would be allowed to rise by 7 percent and 12 percent overall without state oversight, although rates for individual consumers would be able to rise by any amount. Elimination of rate regulation is harmful and undemocratic. It overrides decades of support for rate regulation by state legislators, and in some cases, the vote of the general public. Moreover, insurance is not a typical "product" and is not subject to normal competitive forces. Free market competition alone will not result in rates that are fair and affordable. Insurance policies are exceedingly complex legal documents. Most consumers can't look at an insurance policy and tell for sure whether it offers adequate coverage at a fair price. Comparison-shopping is very difficult because the amount, type and pricing of coverage can vary greatly. Moreover, once a policy is purchased, the real test of its effectiveness may not come for decades -- until a claim arises. Two

examples of the failure of rate deregulation are the recent chaos in California's worker's compensation insurance market and in the Texas homeowner's insurance market. (For the many reasons why insurance is not a normal product for the purposes of regulation, see the attached fact sheet.)

2. **States will also be blocked from preventing insurance abuses triggered by the misuse of classification information**. The deregulation of rates in the draft also deregulates the classification systems insurers use to price customers and policies. Classification systems are regulated by most states because insurers can maximize profits by denying older and sicker people health insurance or by denying inner city residents home and auto insurance. For example, most insurers use credit scoring for insurance rating, which segregates out poorer people for denial or for higher prices. Some insurers now want to use human genome data to price life insurance and Global Positioning Satellites to track consumers in order to price auto insurance. Regulation is required to control classification abuses – the number of potential "innovative" class systems that violate consumer rights and privacy is quite large. Information is also needed to police these abuses, such as zip code data to see where insurers are writing business and how much people are paying for insurance. Although states currently review these class systems to assure fairness and privacy protection, this draft would prohibit them from doing so in the future. Discrimination against people because of their income is not prohibited under the draft, so redlining and other unfair practices are sure to result.

3. **New anti-competitive practices would be sanctioned and encouraged.** Title XVI, Section 1601(c) of the draft deregulates insurance rating and advisory organizations, such as the Insurance Services Office and the National Council on Compensation Insurance. It applies the deregulation of rates and classifications to these organizations, including the two-year flex rating transition period. These organizations function as industry-wide cartels, colluding in the setting of rates or parts of rates, which they file on behalf of many insurance companies. The draft also keeps in place the anti-trust exemption that the insurance industry enjoys under the McCarran Ferguson Act, one of the few industry-wide antitrust exemptions allowed anywhere in federal law. In other words, this draft not only strengthens the ability of insurance executives and these cartel-like organizations to act in an anti-competitive manner, it ties the hands both of states that wish to examine these activities and of persons who are adversely impacted by what would be antitrust violations if it were not for the antitrust exemption. There can be no economic theory that justifies this total deregulation of insurance cartel behavior.

4. **The draft would prohibit any state from determining that competition for personal lines of insurance is not adequate, in order to hold rates in check.** In the wake of Hurricane Andrew, the State of Florida had to act to control price gouging. The draft would prohibit Florida or any state from taking the same steps in response to future natural disasters. Interestingly, Title XVI, section

1601 (g) of the draft does not deregulate medical malpractice insurance, presumably because the market is somewhat non-competitive today. Thus, the drafters are "a little bit pregnant" on the issue of what to do in a non-competitive line of insurance. Doctors are protected from unjust rate increases in today's somewhat non-competitive market, but homeowners, auto owners and small businesses owners, who experience non-competitive markets every decade or so (due to the boom and bust insurance cycle) are not protected.

5. **Low and moderate-income consumers in assigned risk plans will be required to pay excessive rates.** Every state in the nation has created plans to offer insurance to persons unable to find insurance in the normal market. Auto and worker compensation plans (usually known as "assigned risk plans") and home insurance plans (called "FAIR plans") typically offer limited coverage at fairly high rates. Some states regulate rates in these insurance plans carefully, because they (or lenders) require consumers in many case to purchase this insurance and because studies have shown that most consumers placed in these plans are not there because of prior insurance losses, but for other reasons, such as where they live. Title XVI, section 1601 (b) of the draft actually requires that rates paid by consumers in assigned risk and FAIR plans be set at excessive levels, clearly violating current actuarial standards. The draft states that rates paid in these plans may not be less than "the entities' expected losses and expenses, including any net losses incurred in the previous period." Actuarial standards state that recoupment for past period losses is not appropriate in rate setting. The draft seems to not allow profits to be used in setting rates, only losses. It also does not allow the offsetting of insurer expenses by investment income, a standard actuarial practice. Participants in these residual market plans tend to be low income and minority persons who will be asked to pay insurance companies a guaranteed rate of profit using rates that will clearly be excessive. Such rates would be disapproved in many states if not for this ill-advised provision.

6. **The draft requires no representation of consumer interests.** Title XV, Section 1501 (i) of the draft creates two federal officials to act as advocates for the insurance companies, one before international bodies and another before federal agencies. On the other hand, the draft requires absolutely no representation for insurance consumers. The bill does not create an insurance consumer advocate's office to advocate on behalf of consumers before the states, the "Partnership," international bodies or federal agencies. It helps those who need no help -- insurers who can fund such activities and pass the costs on to their policyholders -- and ignores consumers who have very little representation and few resources. To add insult to injury, the only federal agency with extensive consumer protection expertise – the Federal Trade Commission -- is currently forbidden under federal law from even studying insurance issues without a Congressional request. The FTC should be empowered to review consumer issues related to insurance and a consumer

advocate should be established to represent consumer interests before the Partnership and the states.

7. **Uniformity requirements insure that regulation of insurer practices is ineffective and weak.** Several sections of the bill would only allow the home state of an insurer or a large commercial customer to oversee the practices of the insurer or the terms of the commercial policy. This is an extremely dangerous practice, as it is the home state where political pressure on regulators is often most intense. Frequently, former governors and other state officials serve on the boards of directors of such insurers and corporations. An insurer may offer few policies in their home state and many elsewhere. This practice could well provoke state competition to weaken insurance regulations and laws affecting large in-state companies, as states rush to appease companies with tremendous economic clout in their states or attract new companies. In other sections, the draft forces states to accept model laws once a majority of states have adopted these laws. This is a very bad idea. The insurance needs of consumers vary greatly from state to state. Urban states have a very different set of issues than rural states, but rural states will set the standards under these "majority rules" provisions, essentially eliminating any effective legislative capacity for many of the nation's largest states.

8. **Insurers are allowed to choose whether to comply with new life insurance regulations.** In Title V of the draft, life insurers are allowed to file new products at a single point for clearance in multiple states. This could be beneficial to all consumers if all insurers participated and the best experts from the states were used to apply rigorous standards to review products. However, the draft sets up a regulatory "race to the bottom" by allowing insurers to opt out of the multi-state approach at will and return to state-by-state regulation. Insurers should not be allowed to play regulators off each other in order to achieve the weakest possible oversight.

9. **Enforcement of federally mandated uniform standards is vague and unclear.** The drafters of this proposal claim that they are not creating a new federal regulatory body. Instead, they have created a "Partnership" in Title XV of three insurance commissioners, three federal officials and a chair nominated by the state commissioners and selected by the President. The Partnership could take a state to federal court for not complying with the draft's provisions, but it is unclear what the penalty would be if a state refused to comply. For instance, in 1989, Californians voted down the state's system of deregulated insurance rates – the very same system that this draft requires -- in favor of strict regulation. This regulatory regime has proven to be the most effective in the nation (see CFA's comprehensive study of the California system, "Why Not the Best?" at http://www.consumerfed.org/whynotthebest.pdf). Why would the Insurance Commissioner of California willingly agree to be subject to the inadequate protections of this bill when he knows that the current state-based system works well for his constituents?

There is no doubt that some sections of this draft could benefit consumers if consumer protection standards were high, and multi-state enforcement was excellent. These include the anti-fraud provisions in Title X, the single point of filing for life insurance products in Title V and the market conduct requirements in Title II. However, overall this draft is an extraordinary step back for insurance consumers. Rather than "modernize" insurance regulation, this draft would re-open the door to some of the worst insurance abuses of the past, such as cartel pricing and redlining, and tie the hands of states that attempt to stop abusive insurance practices and unfair and disparate pricing. We strongly urge of the drafters of this proposal to return to the drawing board, this time with the needs of consumers and small business owners in mind.

Sincerely,

Travis B. Plunkett
Legislative Director

J. Robert Hunter
Director of Insurance

CC:
Members of the House Financial Services Committee
Members of the Senate Banking Committee

Attachment 3

Why Insurance Is an Essential Public Good, Not Some Normal Product That Can Be Regulated Solely Through Competition

1. *Complex Legal Document.* Most products are able to be viewed, tested, "tires kicked" and so on. Insurance policies, however, are difficult for consumers to read and understand—even more difficult than documents for most other financial products. For example, consumers often think they are buying insurance, only to find they bought a list of exclusions.
2. *Comparison Shopping Is Difficult.* Consumers must first understand what is in the policy to compare prices.
3. *Policy Lag Time.* Consumers pay a significant amount for a piece of paper that contains specific promises regarding actions that might be taken far into the future. The test of an insurance policy's usefulness may not arise for decades, when a claim arises.
4. *Determining Service Quality Is Very Difficult.* Consumers must determine service quality at the time of purchase, but the level of service offered by insurers is usually unknown at the time a policy is bought. Some states have complaint ratio data that help consumers make purchase decisions, and the NAIC has made a national data base available that should help, but service is not an easy factor to assess.
5. *Financial Soundness Is Hard To Assess.* Consumers must determine the financial solidity of the insurance company. One can get information from A.M. Best and other rating agencies, but this is also complex information to obtain and decipher.
6. *Pricing Is Dismayingly Complex.* Some insurers have many tiers of prices for similar consumers—as many as 25 tiers in some cases. Consumers also face an array of classifications that can number in the thousands of slots. Online assistance may help consumers understand some of these distinctions, but the final price is determined only when the consumer actually applies and full underwriting is conducted. At that point, the consumer might be quoted a much different rate than he or she expected. Frequently, consumers receive a higher rate, even after accepting a quote from an agent.
7. *Underwriting Denial.* After all that, underwriting may result in the consumer being turned away.

8. *Mandated Purchase.* Government or lending institutions often require insurance. Consumers who must buy insurance do not constitute a "freemarket", but a captive market ripe for arbitrary insurance pricing. The demand is inelastic.
9. *Incentives for Rampant Adverse Selection.* Insurer profit can be maximized by refusing to insure classes of business (*e.g.,* redlining) or by charging regressive prices.
10. *Antitrust Exemption.* Insurance is largely exempt from antitrust law under the provisions of the McCarran-Ferguson Act.

Compare shopping for insurance with shopping for a can of peas. When you shop for peas, you see the product and the unit price. All the choices are before you on the same shelf. At the checkout counter, no one asks where you live and then denies you the right to make a purchase. You can taste the quality as soon as you get home and it doesn't matter if the pea company goes broke or provides poor service. If you don't like peas at all, you need not buy any. By contrast, the complexity of insurance products and pricing structures makes it difficult for consumers to comparison shop. Unlike peas, which are a discretionary product, consumers absolutely require insurance products, whether as a condition of a mortgage, as a result of mandatory insurance laws, or simply to protect their home or health.

Attachment 4

Collusive Activity by the Insurance Services Organization That Is Allowed by the McCarran-Ferguson Antitrust Exemption

The ISO website has extensive information on the range of services they offer insurance companies. The website illustrates the deep involvement that this organization has in helping to set insurer rates, establishing policy forms, underwriting policies and in setting other rules.

Some examples:

- The page "The State Filing Handbook," promises 24/7 access to "procedures for adopting or modifying ISO's filings as the basis for your own rates, rules and forms."
- The page "ISO MarketWatch Cube" is a "powerful new tool for analyzing renewal price changes in the major commercial lines of insurance . . . the only source of insurance premium-change information based on a large number of actual policies." This price information is available "in various levels of detail—major coverage, state, county and class groupings—for specific time periods, either month or quarter . . . "
- "MarketWatch" supplies reports "that measure the change in voluntary-market premiums (adjusted for exposure changes) for policies renewed by the same insurer group . . . a valuable tool for . . . strategically planning business expansion, supporting your underwriting and actuarial functions . . . "
- "ISO's Actuarial Service" gives an insurer "timely, accurate information on such topics as loss and premium trend, risk classifications, loss development, increased limits factors, catastrophe and excess loss, and expenses." Explaining trend, ISO points out that the insurer can "estimate future costs using ISO's analyses of how inflation and other factors affect cost levels and whether claim frequency is rising or falling." Explaining "expenses" ISO lets an insurer "compare your underwriting expenses against aggregate results to gauge your productivity and efficiency relative to the average . . . " NOTE: These items, predicting the future for cost movement and supplying data on expenses sufficient for turning ISO's loss cost filings into final rates, are particularly anti-competitive and likely, absent McCarran-Ferguson antitrust exemption protection, illegal.
- "ISO's Actuarial Services" web page goes on to state that insurers using these services will get minutes and agendas of "ISO's line actuarial panels to help you keep abreast of ratemaking research and product development."
- The "Guide to ISO Products and Services" is a long list of ways ISO can assist insurers with rating, underwriting, policy forms, manuals, rate quotes, statistics, actuarial help, loss reserves, policy writing, catastrophe pricing, information on specific locations for property insurance pricing, claims handling, information on homeowner claims, credit scoring, making filings for rates, rules and policy forms with the states and other services.

Finally, ISO has a page describing “Advisory Prospective Loss Costs,” which lays out the massive manipulations ISO makes to the historic data. A lengthy excerpt follows:

> Advisory Prospective Loss Costs are accurate projections of average future claim costs and loss-adjustment expenses—overall and by coverage, class, territory, and other categories. Your company can use ISO’s estimates of future loss costs in making independent decisions about the prices you charge for your policies. For most property/casualty insurers, in most lines of business, ISO loss costs are an essential piece of information. You can consider our loss data—together with other information and your own judgment—in determining your competitive pricing strategies.
>
> The insurance pricing problem—Unlike companies in other industries, you as a property/casualty insurer don’t know the ultimate cost of the product you sell—the insurance policy—at the time of sale. At that time, losses under the policy have not yet occurred. It may take months or years after the policy expires before you learn about, settle, and pay all the claims. Firms in other industries can base their prices largely on known or controllable costs. For example, manufacturing companies know at the time of sale how much they have spent on labor, raw materials, equipment, transportation, and other goods and services. But your company has to predict the major part of your costs—losses and related expenses—based on historical data gathered from policies written in the past and from claims paid or incurred on those policies. As in all forms of statistical analysis, a large and consistent sample allows more accurate predictions than a smaller sample. That’s where ISO comes in. The ISO data base of insurance premium and loss data is the world’s largest collection of that information. And ISO quality checks the data to make sure it’s valid, reliable, and accurate. But before we can use the data for estimating future loss costs, ISO must make a number of adjustments, including loss development, loss-adjustment expenses, and trend.
>
> Loss development . . . because it takes time to learn about, settle, and pay claims, the most recent data is always incomplete. Therefore, ISO uses a process called loss development to adjust insurers’ early estimates of losses to their ultimate level. We look at historical patterns of the changes in loss estimates from an early evaluation date—shortly after the end of a given policy or accident year—to the time, several or many years later, when the insurers have settled and paid all the losses. ISO calculates loss development factors that allow us to adjust the data from a number of recent policy or accident years to the ultimate settlement level. We use the adjusted—or developed—data as the basis for the rest of our calculations.
>
> Loss-adjustment expenses—In addition to paying claims, your company must also pay a variety of expenses related to settling the claims. Those include legal-defense costs, the cost of operating a claims department, and others. Your company allocates some of those costs—mainly legal defense—to particular claims. Other costs appear as overhead. ISO collects data on allocated and unallocated loss-adjustment expenses, and we adjust the claim costs to reflect those expenses.
>
> Trend—Losses adjusted by loss-development factors and loaded to include loss-adjustment expenses give the best estimates of the costs insurers will ultimately pay for past policies. But you need estimates of losses in the future—when your new policies will be in effect. To produce those estimates, ISO looks separately at two components of the loss cost—claim frequency and claim severity. We examine recent historical patterns in the number of claims per unit of exposure (the frequency) and in the average cost per claim (the severity). We also consider changes in external conditions. For example, for auto insurance, we look at changes in speed limits, road conditions, traffic density, gasoline prices, the extent of driver education, and patterns of drunk driving. For just three lines of insurance—commercial auto, personal auto, and homeowners—ISO performs 3,000 separate reviews per year to estimate loss trends. Through this kind of analysis, we develop trend factors that we use to adjust the developed losses and loss-adjustment expenses to the future period for which you need cost information.
>
> What you get—With ISO’s advisory prospective loss costs, you get solid data that you can use in determining your prices by coverage, state, territory, class, policy limit, deductible, and many other categories. You get esti-

> mates based on the largest, most credible set of insurance statistics in the world. And you get the benefit of ISO's renowned team of actuaries and other insurance professionals. ISO has a staff of more than 200 actuarial personnel—including about 50 members of the Casualty Actuarial Society. And no organization anywhere has more experience and expertise in collecting and managing data and estimating future losses.

ISO's activities extensively interfere with the competitive market, a situation allowed by the provisions of the McCarran-Ferguson Act's extensive antitrust exemption.

PREPARED STATEMENT OF ROBERT M. HARDY, JR.

VICE PRESIDENT AND GENERAL COUNSEL, INVESTORS HERITAGE LIFE INSURANCE COMPANY

JULY 11, 2006

Good morning Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. My name is Rob Hardy. I am Vice President and General Counsel of Investors Heritage Life Insurance Company in Frankfort, Kentucky, a life insurance company that was started by my grandfather, Harry Lee Waterfield, in 1960. I am the third generation of the Waterfield family that has been involved in the management of the business, and I fully expect several more generations will follow. We have approximately 100 employees and we are licensed to do business in 30 States, primarily in the Midwest and Southeast.

We market life insurance products through various distribution systems; however, our primary markets are in the prearranged funeral market and the final expense market. More than 3,800 agents are appointed to sell our products and we have more than 400,000 policies in force insuring families and individuals across our marketing distribution system.

I am pleased to be here today on behalf of the National Alliance of Life Companies (NALC), a trade group that is primarily composed of small and mid-sized life and health insurance companies. Most of our members are regional in scope operating in up to 30 States and a number of members are licensed in all 50 States. The NALC has been in existence since 1993 and its predecessor organization, The National Association of Life Companies was in existence for more than 35 years. The NALC's primary mission is to promote fair and effective regulation that will allow the industry to thrive for the benefit of policy owners and shareholders.

The NALC supports state regulation of insurance for all participants and all activities and opposes the concept of an optional Federal charter. In fact, I am confident that a number of small and mid-sized life insurance companies that are not members of our association also share the concerns I raise. A Federal charter may make life simpler for some companies, especially large insurance companies, but it is our belief that a Federal regulatory scheme would not be in the best interest of the industry as a whole.

Others may argue that a Federal charter simply allows companies a choice to submit to Federal regulation. We do not believe it is that simple. Proponents of a Federal regulator want a simple, one stop shop to provide greater efficiency and uniformity for the insurance industry. Based on that premise, one could argue for Federalizing first responders, state health or environmental agencies, or even education. Should we simply Federalize all of those functions for the sake of convenience?

No one who believes in our republic can seriously believe that such action would be a good idea. It is recognized that business convenience is often trumped by such factors as, consumer protection and unique market needs impacting a community. Insurance is no different.

The design for a Federal charter, as contemplated in S. 2509, the National Insurance Act (also known as "Optional Federal Charter"), is based on the dual charter banking system. However, there is no national crisis, as there was when the Federal banking system was established, compelling Congress to act in order to bolster consumer confidence. There is no outcry from consumers demanding the Federalizing of insurance. To the contrary, according to ACLI's own report, Monitoring Attitudes of the Public 2004, the life insurance industry is regarded as "either very or somewhat favorable by the majority of people" polled. Further, "a solid majority of consumers agreed that life insurers . . . provide good service and employ highly trained professionals."

Another noteworthy outcome from that report is how consumers feel about life insurance agents. ACLI's study found that "most consumers agreed that life insurance agents exhibit no more high-pressure than other sales people." That's good news.

This is hardly a clarion call from consumers for drastic changes like the creation of an entirely new regulatory structure in the Federal Government.

So what is it we're trying to fix here? We agree that there is still much work to be done to improve market efficiencies and uniformity, but indications are that States are moving in the right direction.

Insurance v. Banking

The primary purpose of insurance regulation is to protect consumers by promoting competitive markets, enforcing insurance laws, and assuring financial soundness and solvency of insurers. It is essential that all financial institutions be subject to efficient regulatory oversight. However, attempting to mirror the system that regulates the banking industry is a lot like trying to put the square peg in a round hole.

First, unlike most bank products, which are based on a national commodity, insurance is sold based on individual needs. Second, the distribution channels are completely different with insurance companies, which rely primarily on agents, while banks rely on consumers coming in to their branches to withdraw or deposit their money. Insurance has to be sold to individuals by individuals.

The Federal banking laws were enacted during a time of a national financial crisis, and without Federal intervention, there was a very real risk of financial collapse. It was extremely important for the Federal Government to back bank deposits to give investors and customers the confidence to trust banks. There is no national crisis in the insurance industry that would require the creation of another Federal bureaucracy.

A Dual Regulatory System Would Create an Unlevel Playing Field

Proponents of S. 2509 suggest that since banks have successfully managed in a dual regulatory world, insurance companies could do the same. However, because of the differences between the industries discussed above, I believe it is inaccurate to compare the two industries.

Small to mid-sized insurance companies tend to be more regional in scope. With the introduction of a Federal regulator for insurance, the rules will necessarily be different and the "playing field" will become unlevel. If all the presumptions supporting S. 2509 hold true (*e.g.* greater efficiency, lower costs of doing business, *etc.*), then small companies, like mine, could be forced to move to a Federal charter in order to remain competitive, or risk being gobbled up, or simply go out of business. Therefore, what is dubbed as "optional" is not really optional at all. It's mandatory.

Effectuating Change Within the Current System

We certainly want to applaud this Committee, in particular, and Congress as a whole, for the vital role it has played in pushing States to take positive reform steps over the past few years. Without Congressional efforts, measures such as the Interstate Compact for Insurance, speed to market reform, the National Association of Registered Agents and Brokers (NARAB) licensing provisions, the financial accreditation system and the improvements being considered for better coordination of market conduct reviews would not have occurred as quickly as they have, if at all. These examples prove that what the States can not or will not do on their own, narrowly tailored Federal legislation and guidance can lead them to do so.

The fact of the matter is that, notwithstanding what proponents would have you believe, the system is not completely broken. It is not perfect and it is in need of improvement but, positive steps have occurred, and the march toward modernizing the state regulatory system continues. We are very concerned that the creation of a new, Federal bureaucracy to regulate insurance will halt the forward progress and create an entirely new set of problems for everyone concerned.

Last month, the 26th and 27th States adopted the Interstate Compact for approval of life insurance policy forms, formally making the Compact functional. A great deal of work went into the drafting of the compact language and passage of compact legislation- a team effort by industry, consumer groups, and regulators. Indeed, it offers a promising opportunity to address many of the speed-to-market concerns you hear about today, without the need for making radical changes in our existing regulatory framework.

Of course, the first question that must be asked is how a Federal charter or any other solution will impact consumers. Improving the state system is in the best interests of consumers. State officials are positioned to be responsive to the needs of the local marketplace and local consumers. We believe consumers are more comfortable with having complaints resolved with regulators in their local communities, rather than calling a hotline in Washington or some regional headquarters. Likewise, consumers have grown comfortable raising public policy concerns regarding insurance issues with elected state officials across the country.

If a new Federal regulator is empowered, those complaints will now be added to the already busy agendas of United States Senators and Members of Congress. Simply put, state governments have a unique and deep knowledge of the insurance markets within their States, and a unique ability to address malfunctions when, and as, they arise. Is it a perfect system? No. Can it be improved? Like everything else in the world, it can, and should, be improved and work continues everyday to make it better and more efficient.

One example of this work is the relationship between the NAIC and NCOIL. I have been involved in the industry for almost 20 years now and I have seen real progress between these two organizations. I believe that progress is vital to the uniformity that we are all seeking.

Kentucky is a perfect example. The interaction between our NCOIL representatives, the Kentucky Office of Insurance and the NAIC was the primary driver in the adoption of the Interstate Compact by our legislature this spring. The relationship with NCOIL allowed our representatives to supplement the background and education that our state legislators received from our Office of Insurance and gave the legislature, as a whole, the confidence to pass the measure.

Choosing a Regulator

It is undeniable that some insurance industry groups have been intimately involved in framing the concept of an optional Federal charter for insurance. We think the industry will be exposed to the very real criticism that it is not industry's intent to create a more aggressive regulator, but a friendlier regulator—a "champion of industry," if you will. Creating an industry-friendly regulator seems somewhat at odds with the primary goal of insurance regulation, which is consumer protection.

Indeed, we need smarter, more efficient regulation, but the primary focus must remain on the protection of policy holders, not the convenience of the industry. This may seem odd coming from someone who runs an insurance company, but we wouldn't be in business if we didn't have the trust of our customers.

In order to create the proposed bureaucracy, the Federal Government will have to pull the expertise from somewhere; and that somewhere will be from the States, which have been regulating insurance for over 150 years. This will have the effect of weakening the state regulatory structure. The ultimate and likely consequence will be that the industry will end up with two weak regulators rather than one strong system.

More importantly, there is a huge presumption that Federal regulation will be more streamlined and more efficient. In looking at other Federal agencies, all staffed by good people with good intentions, few can honestly conclude that this presumption is correct.

From my experience, when I need to speak to someone at a state department of insurance, I have that opportunity. We are not sure that the same result can be achieved under a Federal bureaucracy without it being large enough to handle all of the inquiries that States now receive.

Creation of the Office of National Insurance (ONI)

In creating the Office of National Insurance, the Commissioner will basically have unlimited powers to employ as many people and create as many offices as deemed necessary. A current Federal agency analogous to the proposed Office of National Insurance, based on the individual nature of required services is, arguably, the Social Security Administration (SSA). SSA has over 1,300 offices and employs over 65,000 people to service benefit recipients, not to mention constituent support provided by every Member of Congress. The NAIC has indicated that the state departments of insurance handle over 4 million consumer inquiries, including complaints. Can you imagine the Federal bureaucracy necessary just to handle even a fraction of those inquiries? And this would be in addition to the thousands of state insurance regulators currently employed, who will continue to do their jobs at the state level. I imagine we could end up with more insurance regulators per capita than any other area of business.

Funding

Funding is also a huge issue with regard to how the funding of a Federal regulator will affect the States. Fees, assessments, and penalties will be charged to federally chartered companies and producers. While States will still be allowed to receive premium taxes in the short-term, they will no longer receive revenues from other fees and assessments; for example, examination fees from federally licensed insurers and producers. This will likely have a negative impact on state budgets.

Curiously, Section 1122 of the bill provides that fees and assessments charged against the companies and producers are not considered government or public mon-

ies. How can the government take money from the private sector and that revenue not be considered "government or public monies"?

Further, according to the NAIC, it took $880 million to run the various state insurance departments. How much will it take to run the Office of National Insurance? No one knows the answer to that question, but it is clear that the Commissioner will have the discretion to assess whatever it takes. Since the intent is to establish a parallel system similar to banking, it should be noted that banking is regulated by at least six different regulatory bodies, employing over 30,000 people.

Preemption

The recent Federal district court decision in *OCC v. Spitzer*, giving Federal agencies full authority to promulgate preemption regulations, shows the extent to which Federal agencies with unbridled authority are willing to go to usurp States' rights. In that case, the court determined that the Office of the Comptroller of the Currency (OCC) possesses exclusive governmental enforcement authority, which OCC granted itself by regulation, with respect to all laws—Federal and state—that apply to national banks. In short, it means the OCC has the authority to prohibit States from using the court system to enforce applicable state laws against national banks. This bill gives the Commissioner of Insurance that same degree of authority. As a matter of public policy, this is a concern to us because, according to this Federal court, States will have no standing to use the court system to inspect, examine, regulate or compel action by a national insurer or producer operating within its borders.

Global Marketplace

We unquestionably live in a global marketplace today. But the United States still has the most sophisticated and largest insurance market in the world. I think it is reasonable to say that any company in the world that wants to do business here is doing business here. In recent years, this process has been streamlined and now all 50 States and the District of Columbia accept the NAIC's Uniform Certificate of Authority Application. This process has helped foreign and domestic companies alike.

Conclusion

The NAIC has worked hard since 2000 to modernize the regulatory framework and improve efficiencies in the process. Congressional initiatives have gone a long way in prompting the NAIC and the various States to adopt necessary model laws that will improve the state-based system. Now is not the time to create a whole new bureaucracy. Pay close attention and prod when necessary to keep the modernization effort going. There are better ways to improve efficiency, but regulation of the insurance industry should remain with the States. While Federal legislative tools to push States to improve would be a welcome addition, the creation of a large, new Federal bureaucracy is not necessary. Thank you very much for the opportunity to share the views of NALC today.

PREPARED STATEMENT OF SCOTT A. SINDER

MEMBER, THE SCOTT GROUP

JULY 11, 2006

Good morning, Chairman Shelby, Ranking Member Sarbanes and members of the Committee. Thank you for the opportunity to testify before you today on behalf of The Council of Insurance Agents & Brokers (The Council), which I serve as general counsel. We are grateful for the initiation of this effort to explore the contours of the current regulatory structure of the insurance industry and the potential need for change.

Insurance regulatory reform, which is critical for the long-term health of the industry, is long overdue. Modernization of the insurance regulatory structure is an important element in maintaining a strong, vibrant insurance sector and is essential to allow the marketplace to evolve in order to address the needs of insurance policyholders in the 21st century.

The Council represents the nation's leading insurance agencies and brokerage firms. Council members specialize in a wide range of insurance products and risk management services for business, industry, government, and the public. Operating both nationally and internationally, Council members conduct business in more than 3,000 locations, employ more than 120,000 people, and annually place more than 80 percent—well over $200 billion—of all U.S. insurance products and services protecting business, industry, government and the public at-large, and they administer billions of dollars in employee benefits. Since 1913, The Council has worked

in the best interests of its members, securing innovative solutions and creating new market opportunities at home and abroad.

Executive Summary

Insurance regulatory reform is long overdue. The State regulatory system is simply not equipped to handle the increasingly complex and sophisticated insurance marketplace, and the patchwork quilt of insurance regulation has a very real impact on the availability and affordability of coverage for insurance consumers. This is why The Council is a strong supporter of insurance regulatory reform and is working so hard for change.

The Council is very grateful for the work of Senators Sununu and Johnson in drafting The National Insurance Act of 2006, S. 2506. We believe the proposal is an excellent framework on which to build a dialog around the issues of insurance regulatory modernization. We endorse the legislation for many reasons, not the least of which is its purely voluntary nature—voluntary for companies and agents/brokers, as well as consumers. The bill provides real choice for all participants in the insurance marketplace.

The Council has been a strong advocate for such legislation for a number of years. We hope progress is made on S. 2506, but all of us know that this is a difficult set of issues and debate will take a considerable amount of time. It is a major undertaking with a great number of issues to be resolved. Political reality dictates that it will not be an easy process, nor will it be quick. Meanwhile, however, insurance regulation is in desperate need of reform. In order to better serve our policyholders and clients, we need practical solutions to real marketplace problems. We hope that debate over the Optional Federal Charter will not stop the members of this committee from considering less controversial incremental reforms that address fundamental flaws in the system and for which solutions are readily at hand.

Regulation of surplus lines insurance provides a perfect example. Although the purchase of surplus lines insurance is generally considered to be less regulated than the admitted marketplace, in reality the regulatory structure governing such coverage is quite burdensome and restrains the availability of coverage. When surplus lines activity is limited to a single state, regulatory issues are minimal. When activity encompasses multiple States, however, which is the norm in the surplus lines market, full regulatory compliance is difficult, if not impossible. Thus, the difficulty of complying with the inconsistent, sometimes conflicting requirements of multiple state laws is a real problem. Simply keeping track of all the requirements can be a Herculean task.

The House Financial Services Committee is considering legislation that would fix this problem. H.R. 5637, the Nonadmitted and Reinsurance Reform Act, would streamline surplus lines regulation by consolidating regulatory oversight of surplus lines transactions into a single state—the insured's home state—thus eliminating the overlapping, conflicting rules that inhibit the non-admitted marketplace and harm consumers. The proposal does not deregulate the non admitted insurance marketplace or reduce consumer protections. Even the National Association of Insurance Commissioner's most recent past president, Diane Koken of Pennsylvania, has acknowledged that this is an area where Federal intervention may well be needed "to resolve conflicting state laws regulating multi-state transactions."

Surplus lines regulatory reform will not detract at all from the debate over the OFC, nor is a substitute for that legislation. But in the meantime, it is an achievable reform, a somewhat uncontroversial reform, and its resolution will save millions of dollars for carriers and consumers and, we believe, ultimately increase compliance with state premium tax requirements by resolving the conflicts that make compliance difficult if not impossible today.

Optional Charter—Introduction

The insurance marketplace has changed and evolved in the millennia since ancient traders devised systems for sharing losses and in the centuries since the Great Fire of London led to the creation of the first fire insurance company. Indeed, insurance has become increasingly sophisticated and complex in the last 60 years, since enactment of the McCarran-Ferguson Act, which preserved a state role in the regulation of insurance.

In the United States, insurance has historically been governed principally at the state, rather than the national, level. This historic approach, codified by McCarran-Ferguson in 1945, made sense when risks and the impact of losses due to those risks was concentrated in relatively small geographic areas and the insurance markets were similarly small. Initially, risks were generally local and losses were most likely to be felt by the local community. Fire, for example, was a major threat not only to individual property-owners, but to entire communities because of the wide-

spread devastation fire can cause. As populations and economies grew, so did the risks, and the impact of losses became more widespread. The pooling of risks has grown ever wider, and more sophisticated as well.

State regulation of insurance addressed those needs. The primary objective of insurance regulation has always been to monitor and regulate insurer solvency because the most essential consumer protection is ensuring that claims are paid to policyholders. State regulation initially advanced that goal by giving consumers with no direct knowledge of carriers based in other communities comfort that they would be able to—and would—pay claims when they came due. This, in turn, led to increased availability and affordability of coverage because carriers were able to expand their reach, making the insurance marketplace more competitive.

But things have changed. While some risks—and insurance markets—remain local or State-based, in general, insurance has become a national and international marketplace in which risks are widely spread and losses widely felt. The terrorist attack on the World Trade Center and the devastation caused by Hurricane Katrina are, perhaps, the two most notable examples, but many policyholders, particularly in the commercial sector, have risks spread across the country and the globe. Rather than encouraging increased availability and improving the affordability of insurance to cover such risks, the state regulatory system does just the opposite. By artificially making each state an individual marketplace, it constrains the ability of carriers to compete and thereby reduces availability and affordability.

Insurance Regulatory Reform: Despite recent improvements, there remain significant problems in the state insurance regulatory system; because the States cannot solve these problems on their own, congressional action is necessary.

Although the state insurance regulators, through the National Association of Insurance Commissioners (NAIC), have attempted to institute regulatory reforms without Federal involvement, the reality is that today's marketplace demands far more dramatic action than the States alone are able to provide. As I have mentioned, insurance is no longer the local market it once was. It is a national and international marketplace, the development of which is far outstripping the pace of reform efforts by state regulators and legislatures. The state regulatory system is simply not equipped to handle this increasingly complex and sophisticated marketplace. Competition and efficiency in the insurance industry lag behind other financial services sectors due to the regulatory inefficiencies and inconsistencies in the state insurance regulatory system. These inefficiencies and inconsistencies must be addressed if the insurance sector is going to be able to keep up with the pace of change in the rapidly evolving global marketplace and thereby provide adequate and affordable coverage to insurance consumers.

The Council regards itself as a pioneer within our industry with respect to regulatory modernization, although reform is a frustratingly long process. We formed our first internal committee to address the problems of interstate insurance producer licensing more than 60 years ago. Our efforts were finally rewarded with the enactment of the NARAB provisions of the Gramm-Leach-Bliley Act (GLBA) a few years ago—a first step on the road to insurance regulatory reform. The proposed National Insurance Act is the next step on the road to modernization.

I want to emphasize at the outset that we are not advocating deregulation of the insurance marketplace or any reduction in consumer protections. What we are advocating—as we did with NARAB and producer licensing reform—is fixing the current regulatory system to allow insurance companies and producers to have a choice between state and Federal oversight. Many insurers and producers will likely choose to remain within the state system because it works best based on the size of their business and their customer base. For the same reasons, others will choose the Federal option. For this latter group, jettisoning the current multi-state system for a single Federal regulator makes eminent good sense, allowing them to avoid the overlapping, burdensome dictates of 55 jurisdictions for a single regulator and thereby easing regulatory burdens—and doing so without sacrificing consumer protections. We believe the long-term effects of such reform on the marketplace will ultimately benefit the consumer by increasing capacity and improving availability of coverage.

Continuing Problems Under the Current Regulatory System

Although the States have made some strides in recent years in simplification and streamlining regulatory requirements, almost all the concrete progress has been in the producer licensing area—thanks to the enactment of GLBA's NARAB provisions. NARAB compliance notwithstanding, there remain several problem areas in the interstate licensing process that impose unnecessary costs on our members in terms of time and money. In addition, insurance companies face problems doing business on a multi-state basis, and recent efforts by the States to streamline rate and policy

form approval processes have not proven very successful. The operation of and access to alternative markets—such as surplus lines and risk retention groups—is also hampered by unnecessarily cumbersome and duplicative regulatory requirements. These continuing problems with the state-by-state insurance regulatory process has led us to the following conclusion: regulatory reform is needed, and it is needed now.

Producer Licensure: Welcome Improvements, but Incomplete Reform

The NARAB provisions included in GLBA required that at least 29 States enact either uniform agent and broker licensure laws or reciprocal laws permitting an agent or broker licensed in one state to be licensed in all other reciprocal States simply by demonstrating proof of licensure and submitting the requisite licensing fee.

After enactment of GLBA, the NAIC pledged not only to reach reciprocity, but ultimately to establish uniformity in producer licensing. The regulators amended the NAIC Producer Licensing Model Act (PLMA) to meet the NARAB reciprocity provisions, and their goal is to get the PLMA enacted in all licensing jurisdictions. As of today, nearly all the States have enacted some sort of licensing reform, and the NAIC has officially certified that a majority of States have met the NARAB reciprocity requirements, thereby averting creation of NARAB. This is a good effort, but problems remain; there is still much work to be done to reach true reciprocity and uniformity in all licensing jurisdictions.

Although most of the States have enacted the entire PLMA, a number of States have enacted only the reciprocity portions of the model. Of the States that have enacted the entire PLMA, several have deviated significantly from the model's original language. One state has enacted licensing reform that in no way resembles the PLMA. And two of the largest States in terms of insurance premiums written, Florida and California, have not enacted legislation designed to meet the NARAB reciprocity threshold at all.

The inefficiencies and inconsistencies that remain in producer licensing affect every insurer, every producer and every insurance consumer. Many Council member firms continue to hold hundreds of resident and non-resident licenses across the country. For some, the number of licenses has actually increased since enactment of GLBA. In addition to initial licenses, Council members face annual renewals in 51-plus jurisdictions, in addition to satisfying all the underlying requirements and post-licensure oversight. Undeniably, progress in streamlining the producer licensing process has been made since GLBA's NARAB provisions were enacted in 1999, but these numbers—and, more critically, the regulatory and administrative burdens they represent—vividly demonstrate that the job is not yet finished. Most States retain a variety of individual requirements for licensing, and they all differ with respect to fees, fingerprinting and certifications, among other requirements.

In addition to the lack of full reciprocity in licensing procedures for nonresidents, the standards by which the States measure compliance with licensing requirements differ from state to state, as well. These include substantive requirements—pre-licensing education, continuing education and criminal background checks, for example—as well as administrative procedures such as agent appointment procedures and license tenure and renewal dates. While these may seem like small issues, they can easily turn into large problem for insurance producers licensed in multiple jurisdictions: they must constantly renew licenses throughout the year, based upon the individual requirements in each State. In addition to the day-to-day difficulties the current set-up imposes, this inconsistent application of law among the States inhibits efforts to reach full reciprocity. Some States may be disinclined to license as a non-resident a producer whose home state has "inferior" licensing standards, even a state with similar or identical statutory language. In fact, several States that have failed to adopt compliant licensure reciprocity regimes (notably California and Florida) claim their refusal is based on this absence of uniform standards—thus implying that the standards of other States do not measure up.

A third major area in need of streamlining is the processing of license applications. Although a uniform electronic producer licensing application is now available for use in many States—arguably, the biggest improvement in years—several states, including Florida and South Carolina, do not use the common form, and in States that use the form, there is no common response mechanism. Each state follows up on an application individually, which can be cumbersome and confusing.

Thus it is clear that, despite the revolutionary NARAB achievements, comprehensive reciprocity and uniformity in producer licensing laws remains elusive, and it does not appear the NAIC and the States are capable of fully satisfying those goals. Indeed, until recently, Florida completely barred non-residents from being licensed to sell surplus lines products to Florida residents or resident businesses. And several States including Florida required nonresident agents and brokers who sold a policy of an admitted company to their residents or resident businesses to pay a

mandated "countersignature fee" to a registered agent in order to complete that transaction. These practices have been terminated only because The Council filed a lawsuit in every jurisdiction in which countersignatures were required. Countersignature laws in Florida, South Dakota, Nevada, Puerto Rico, and the Virgin Islands have been struck down by Federal judges in those jurisdictions, and the West Virginia legislature repealed its law rather than defend it in court. The rulings tossing out the countersignature laws in Nevada and the Virgin Islands are still in the appeals process and are not yet final.

Access to Alternative Markets

In the last several years, high rates for property and casualty insurance have been a serious problem for many mid-sized and larger commercial firms. Hard markets such as these cause availability to decrease and the cost of coverage to increase. During these periods, insureds—particularly sophisticated commercial insureds—are increasingly drawn to the appeal of alternatives to the traditional, regulated marketplace to expand their coverage options and hold down costs. There are two excellent mechanisms in place that offer such alternative markets: surplus lines insurance and risk retention groups. Although surplus lines insurance and insurance purchased through risk retention groups technically are less regulated than insurance in the admitted market, there are, nonetheless, state regulatory requirements and Federal laws that apply to these alternative market mechanisms that prevent this marketplace from fully realizing its potential. Creation of an optional Federal charter would transform these markets, increasing options and decreasing costs for insurance consumers.

Surplus Lines. Surplus lines insurance provides coverage for unique, unusual or very large risks for which insurance is unavailable in the admitted market. A surplus lines product is an insurance product sold by an insurance company that is not admitted to do business in the state in which the risk insured under the policy is located. In essence, the insured goes to wherever the insurance company is located to purchase the coverage. The insurer may be in another state, or it may be in Great Britain, Bermuda or elsewhere. Potential insureds can procure this insurance directly, but they generally do so through their insurance brokers. In short, "surplus lines" are: (1) insurance products sold by insurance carriers that are not admitted (or licensed) to do business in a state, (2) to sophisticated commercial policyholders located in that state, (3) for insurance coverages that are not available from insurers admitted (or licensed) to do business in that state. Surplus lines products tend to be more efficient and a better fit for commercial coverages because they can be tailored to the specific risk profiles of insured with specialized needs.

Surplus lines insurance is universally recognized as an important component of the commercial property and casualty insurance marketplace in all States, and commercial property and casualty business is done increasingly through the surplus lines marketplace. In fact, in 2004, $33 billion in premium was purchased by policyholders in the surplus lines market.

Although the purchase of surplus lines insurance is legal in all States, the regulatory structure governing such coverage is a morass. When surplus lines activity is limited to a single state, regulatory issues are minimal. When activity encompasses multiple States, however, full regulatory compliance is difficult, if not impossible. And I should note that multi-State surplus lines policies are the norm rather than the exception because surplus lines coverage is uniquely able to address the needs of insureds seeking coverage in more than one State. Thus, the difficulty of complying with the inconsistent, sometimes conflicting requirements of multiple State laws is a real problem. Simply keeping track of all the requirements can be a Herculean task. For example: Maryland and the District of Columbia require a monthly "declaration" of surplus lines business placed, but only require payment of premium taxes on a semi-annual basis; Virginia, in contrast, requires that a declaration be filed and taxes be paid quarterly; New Jersey has 36 pages of instructions for surplus lines filings, including a page discussing how to number the filings and a warning not to file a page out of sequence because that would cause a rejection of the filing and could result in a late filing.

As a general matter, state surplus lines regulation falls into five categories: (i) taxation; (ii) declinations; (iii) insurer eligibility; (iv) regulatory filings; and (v) producer licensing and related issues.

Taxes: States have inconsistent and sometimes conflicting approaches regarding the allocation of premium taxes, which can lead to double taxation and confusion when a surplus lines policy involves multi-State risks.

- Single situs approach—100 percent of the premium tax is paid to the insured's State of domicile or headquarters State. This approach is imposed by some

States regardless of what percentage of the premium is associated with risks insured in the state. Virginia, for example, utilizes this rule.

- Multi-State approach—Premium tax is paid to multiple States utilizing some method of allocation and apportionment based upon the location of the risk(s). Because there is no coordination among the States on allocation and apportionment, determination of the amount of tax owed to each state is left to brokers and insureds. If a policy covers property insured in a single situs state and in an apportionment state, double taxation also is unavoidable. A majority of the States utilize this basic rule but the manner in which it is implemented (including the allocation formula) can vary wildly.
- No clear requirement—More than a dozen States that impose surplus lines premium taxes do not have statutory or regulatory provisions indicating the state's tax allocation method, leaving it up to the insured and the insured's broker to determine how to comply with the state law. In such States, determination as to whether any tax should be paid and whether the allocation of any such tax is permissible and appropriate is often based on informal guidance from state insurance department staff.

In addition to the near-impossibility of determining the correct allocation for surplus lines premium tax in a way that does not risk paying too much or too little tax, the differences among the States with respect to tax rates, tax exemptions, taxing authorities, and the timing of tax payments impose huge burdens on surplus lines brokers (who are responsible for paying the taxes if they are involved in the placement) and on commercial consumers, who must navigate these requirements on their own for placements that do not involve a broker and who ultimately bear the costs of not only the tax but the administrative costs of compliance in any event.

For example, state surplus lines premium tax rates range from about 1 percent to 6 percent. In one state, Kentucky, surplus lines taxes are levied not at the state level but at the municipality level. Aon, a member of The Council, reports that in order to properly rate taxes in Kentucky, it must use electronic maps to determine the city and county in which a risk is located. There are hundreds of cities and counties in the state. Some counties charge a tax in lieu of the city tax, some charge it in addition to the city tax, some charge the difference between the city and county taxes, and some do not charge a city or county tax at all.

The due dates for premium taxes vary even more widely across the States. Surplus lines premium taxes are due:

- Annually on a date certain in some States; the dates vary but include: January 1, January 31, February 15, March 1, March 15, April 1, and April 16;
- Semi-annually in some States. Again, the dates vary but include: February 1 and August 1, February 15 and August 15, and March 1, and September 1;
- Quarterly in some States (generally coinciding with the standard fiscal quarters);
- Monthly in some States; and
- Sixty days after the transaction in some States.

The States also differ with respect to what is subject to the tax, what is exempt from the tax, whether governmental entities are taxed, and whether brokers' fees are taxed as part of or separately from the premium tax (if they are taxed at all). As you can see, determining the proper surplus lines tax payment for the placement of a multi-State policy is a daunting task.

Declinations: Most States require that an attempt be made to place coverage with an admitted insurer before turning to the surplus lines market. Some States specifically require that one or more licensed insurers decline coverage of a risk before the risk can be placed in the surplus lines market. If it is determined that a portion of the risk is available in the admitted market, many States require that the admitted market be used for that portion of the risk.

State declination requirements are inconsistent and conflicting, and the methods of proving declinations vary tremendously, from specific requirements of signed affidavits to vague demonstrations of "diligent efforts." For example, Ohio requires five declinations, but does not require the filing of proof of the declinations. New Mexico requires four declinations and submission to the insurance department of a signed, sworn affidavit. Hawaii does not require declinations but prohibits placement of coverage in the surplus lines market if coverage is available in the admitted market. Further, Hawaii does not require filing of diligent search results but requires brokers to make such information available to inspection without notice by the state insurance regulator. In California, prima facie evidence of a diligent search is established if an affidavit says that three admitted insurers that write the particular line

of insurance declined the risk. In Alabama, the requirement is much more vague. The broker is required only to demonstrate "a diligent effort" but no guidance is provided suggesting what constitutes such an effort. In Connecticut, the broker must prove that only the excess over the amount procurable from authorized insurers was placed in the surplus lines market.

Insurer Eligibility: Most States require that a surplus lines insurer be deemed "eligible" by meeting certain financial criteria or having been designated as "eligible" on a state-maintained list. Although a majority of the States maintain eligibility lists (also called "white lists"), in many of the remaining States the surplus lines broker is held responsible for determining if the non-admitted insurer meets the state's eligibility criteria. In addition, although the NAIC maintains a list of eligible alien (non-U.S.) surplus lines insurers that is used by four States, this does not seem to have any bearing on the uniformity of the eligible lists in the remaining States. As one would expect, as a result of differing eligibility criteria from state to state—and changes in individual States from year to year—the insurers eligible to provide surplus lines coverage varies from state to state. This can make it exceedingly difficult to locate a surplus lines insurer that is "eligible" in all States where a multi-state policy is sought.

The flip side of insurer eligibility is also an issue: that is, when multi-state surplus lines coverage is placed with an insurer that is an admitted insurer (not surplus lines) licensed in one of the States in which part of the risk is located. This is problematic because surplus lines insurance cannot be placed with a licensed insurer. In these situations, more than one policy will have to be used, or the insured will have to use a different surplus lines carrier—one that is not admitted, but "eligible" in all States in which the covered risks are located.

Filings: Most States require one or more filings to be made with the State insurance department in connection with surplus lines placements. These may include filings of surplus lines insurer annual statements, filings regarding diligent searches/ declinations, filings detailing surplus lines transactions, and filings of actual policies and other informational materials. Some States that do not require the filing of supporting documentation require brokers to maintain such information and make it available for inspection by the regulator.

Like other surplus lines requirements, State filing rules vary widely. Some States require signed, sworn affidavits detailing diligent search compliance; some require such affidavits to be on legal sized paper, others do not; some States require electronic filings, others require paper; some States have specific forms that must be used, others do not; some States require the filing of supporting documentation, some do not—although some of those States place the burden on the broker, who is required to store the information in case regulatory inspection is required. In addition, although most filings are required to be submitted to the State insurance regulator, in at least one State, Kentucky, municipalities also require submission of surplus lines materials. There are hundreds of cities and counties in the State and each requires a separate quarterly and annual report by the licensee. As with the tax situation, this creates a terrible burden on surplus lines insurers and brokers, and unnecessarily increases consumer costs.

Depending on the State in question, filings can be required annually, quarterly, monthly or a combination thereof. For example, several States require the filing of surplus lines information in the month following the transaction in question: Colorado requires such filings by the 15th of the month; and the District of Columbia by the 10th. Other States peg the filing date to the date of the transaction or the effective date of the policy: Florida requires filing within 21 days of a transaction; Idaho within 30 days; Kansas within 120 days; Missouri requires filing within 30 days from the policy effective date and New York 15 days from the effective date; Illinois and Michigan require semi-annual filings of surplus lines transactions. Although Illinois does not require filing of affidavits, carriers must maintain records of at least three declinations from admitted companies for each risk placed in the surplus lines market. Some States have different deadlines for different filings. Louisiana, for example, requires quarterly filings of reports of all surplus lines business transacted, and "diligent search" affidavits within 30 days of policy placement. North Dakota, in contrast, requires a single annual filing of all surplus lines transactions, and allows 60 days for the filing of "diligent search" affidavits.

In addition, some States treat "incidental exposures"—generally relatively small surplus lines coverages—differently from more substantial coverages with respect to filing requirements. States have differing definitions of what constitutes incidental exposures and who has to make required filings for such an exposure: some States require the broker to make the filings; others the insured; and some require no filings at all for incidental exposures.

a. Producer Licensing and Related Issues. In addition to the substantial issues outlined above, there are other vexing regulatory issues facing the surplus lines marketplace:

- Producer Licensing: All States require resident and non-resident surplus lines producers to be licensed, and all States have reciprocal processes in place for non-resident licensure. Nevertheless, there remain significant differences among some States with respect to producer licensing that can delay the licensure process, particularly for non-residents. For example, most States require that an individual applying for a surplus lines broker license be a licensed property and casualty producer. The States vary, however, as to how long the applicant must have held the underlying producer license. In addition, some, but not all, States exempt from licensure producers placing multi-State coverage where part of the risk is located in the insured's home State. In States without such an exemption, the laws require a producer to be licensed even for such incidental risks.
- Sophisticated Commercial Policyholders: Some States exempt "industrial insureds" from the diligent search, disclosure, and/or filing requirements. The definition varies among the States, but generally industrial insureds are analogous to the concept of sophisticated commercial insureds. They are required to have a full time risk manager, minimum premium requirements for selected lines of coverage, and a minimum number of employees. If an insured meets a State's criteria, the insured's surplus lines transaction is exempt from the surplus lines requirements, as provided for by the State.
- Automatic Export: A number of States allow certain risks to be placed directly in the surplus lines market. This is called "automatic export" because no diligent search is required before the risk is exported from the admitted market to the surplus lines market. As with every other surplus lines requirement, however, the States are not uniform in their designation of the risks eligible for automatic export.
- Courtesy Filings: A courtesy filing is the payment of surplus lines tax in a State by a surplus lines broker who was not involved in the original procurement of the policy. Courtesy filings are helpful when a broker places a multi-State filing that covers an incidental risk in a State in which the broker is not licensed. The problem is that most States either prohibit courtesy filings or are silent as to whether they will be accepted. This uncertainty essentially requires surplus lines producers to be licensed even in States where they would otherwise be exempt.

The Nonadmitted and Reinsurance Reform Act. In the House, Representatives Ginny Brown-Waite (R-FL) and Dennis Moore (D-KS) have sponsored H.R. 5637, the Nonadmitted and Reinsurance Reform Act. The bill proposes a common-sense reform that would streamline surplus lines regulation and ease regulatory burdens, while preserving consumer protections and the financial soundness of the surplus lines marketplace, which is the most important protection of all. The proposed legislation would provide an effective resolution to the current regulatory morass by focusing on the home State of the insured: all premium taxes would be payable to the insured's home State and surplus lines insurance transactions would be governed by the rules of the insured's home State.

The Council supports the legislation and efforts to initiate insurance regulatory modernization by focusing on surplus lines. We look forward to seeing the bill move through the Financial Services Committee and on to the full House for consideration. Having said that, surplus lines is but one segment of a huge industry. While H.R. 5637 is an excellent start for insurance regulatory modernization, it is clear that more global reform—such as the National Insurance Act—will be necessary to address the full range of regulatory issues affecting the insurance marketplace.

I note that Business Insurance, the insurance trade publication, in its June 26, 2006 issue, published an editorial in support of the Act, stating that "the measure would bring much-needed uniformity to the taxation and regulation of nonadmitted insurers while giving risk managers a streamlined process for tapping that vital market . . . While we would prefer comprehensive insurance regulatory reform, including the optional Federal charter, we support incremental change. Even a little reform is far better than none at all."

In addition, although the state regulators have been silent on the proposed legislation, the NAIC has acknowledged that congressional action on surplus lines reform may be necessary. In testimony in June 2005, before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Diane Koken, the Pennsylvania Insurance Commissioner and then-president of the NAIC, stated

> Either Federal legislation, or another alternative such as an Interstate Compact, may be needed at some point to resolve conflicting state laws regulating multi-state transactions. The area where this will most likely be necessary is surplus lines premium tax allocation. Federal legislation might also be one option to consider to enable multi-state property risks to access surplus lines coverage in their home States under a single policy subject to a single set of requirements.

b. Risk Retention Groups. Enacted in 1981, the Product Liability Risk Retention Act was developed by Congress in direct response to the insurance "hard market" of the late 1970's. The current version of the law—the Liability Risk Retention Act of 1986—was enacted in response to the "hard market" of the mid-1980s and expanded the coverage of the Act to all commercial liability coverages. Risk Retention Groups (RRGs) created under the Act are risk-bearing entities that must be chartered and licensed as an insurance company in only one State and then are permitted to operate in all States. They are owned by their insureds and the insureds are required to have similar or related liability exposures; RRGs may only write commercial liability coverages and only for their member-insureds.

The rationale underlying the single-State regulation of RRGs is that they consist only of "similar or related" businesses which are able to manage and monitor their own risks. The NAIC has recognized that the purpose of Risk Retention Groups is to "increase the availability of commercial liability insurance."

Speed to Market

The State-by-State system of insurance regulation gives rise to problems outside the area of producer licensing that require immediate congressional attention, as well. Although these problems appear to affect insurance companies more than insurance producers, the unnecessary restraints imposed by the State-by-State regulatory system on insurers harm producers as much as companies because they negatively affect the availability and affordability of insurance, and, thus, our ability to place coverage for our clients.

Most Council members sell and service primarily commercial property/casualty insurance. This sector of the insurance industry is facing severe challenges today due to a number of factors, including: the losses incurred as a result of the September 11 terrorist attacks; increased liability expenses for asbestos, toxic mold, D&O liability and medical malpractice; and years of declining investment returns and consistently negative underwriting results. Some companies have begun to exit insurance markets as they realize that they can no longer write these coverages on a break-even basis, let alone at a profit. The end result is increased prices and declining product availability to consumers. This situation is exacerbated by the current State-by-State system of insurance regulation.

The current U.S. system of regulation can be characterized as a prescriptive system that generally imposes a comprehensive set of prior constraints and conditions on all aspects of the business operations of regulated entities. Examples of these requirements include prior approval or filing of rates and policy forms. Although the prescriptive approach is designed to anticipate problems and prevent them before they happen, in practice, this approach hinders the ability of the insurance industry to deal with changing marketplace needs and conditions in a flexible and timely manner. This approach also encourages more regulation than may be necessary in some areas, while diverting precious resources from other areas that may need more regulatory attention.

It is also important to note that insurers wishing to do business on a national basis must deal with 51 sets of these prescriptive requirements. This tends to lead to duplicative requirements among the jurisdictions, and excessive and inefficient regulation in these areas. Perhaps the best (or worst, depending upon your perspective) example of this are the policy form and rate pre-approval requirements still in use in many States. Over a dozen States have completely de-regulated the commercial insurance marketplace for rates and forms, meaning that there are no substantive regulatory approval requirements in these areas at all. Other States, however, continue to maintain pre-approval requirements, significantly impeding the ability of insurers to get products to market. Indeed, some studies have shown that it can take as much as 2 years for a new product to be approved for sale on a nationwide basis. Banking and securities firms, in contrast, can get a new product into the national marketplace in 30 days or less. The lag time for the introduction of new insurance products is unacceptable. It is increasingly putting the insurance industry at a competitive disadvantage as well as undermining the ability of insurance consumers to access products that they want and need.

Let me give you an example that all Council members are familiar with: a few years ago, PAR, an errors and omissions captive insurer sponsored by The Council,

sought to revise its coverage form. In most States, PAR was broadening coverage, although in a few cases, more limited coverage was sought. PAR had to refile the coverage form in 35 States where PAR writes coverage for 65 insureds. After 2 years and $175,000, all 35 States approved the filing. Two years and $5,000 per filing for a straightforward form revision for 65 sophisticated policyholders is unacceptable and is symptomatic of the problems caused by outdated rate and form controls.

We support complete deregulation of rates and forms for commercial lines of insurance. There is simply no need for such government paternalism. Commercial insureds are capable of watching out for their own interests, and a robust free market has proved to be the best price control available. The proposed National Insurance Act contemplates this approach by restricting the Federal regulator's authority to dictate rates or the determination of rates.

Solutions—Congressional Leadership and Action Is Critical if Insurance Regulatory Reform Is To Become a Reality

Studies have shown that the regulatory modernization efforts attempted by the NAIC in the past several years have been the direct result of major external threats—either the threat of Federal intervention, or the wholesale dislocation of regulated markets. It follows that there is no guarantee the State-based system will adopt further meaningful reforms without continued external threats to the States' jurisdiction. Too much protectionism and parochialism interferes with the marketplace, and the incentive for reform in individual States simply does not exist without a Federal threat. Thus, congressional involvement in insurance regulatory reform is entirely in order and, in fact, overdue. Broad reforms to the insurance regulatory system are necessary to allow the industry to operate more efficiently, to enable the insurance industry to compete in the larger financial services industry and internationally, and to provide consumers with a strong, competitive insurance market that brings them the best product at the lowest cost.

As we all know, there are, essentially, two approaches to insurance regulatory reform currently under consideration—issue-by-issue reform and the optional Federal charter. These approaches, although different, are not necessarily mutually exclusive—partial reform now does not rule out further reform in the future. Indeed, both may be necessary in order to bring comprehensive reform to the insurance marketplace. As we have mentioned, The Council strongly supports the surplus lines reform that is now under consideration in the House and believes such legislation will not detract at all from the debate over the OFC, nor is a substitute for that legislation. In fact, we believe it will help set the stage for creation of an optional Federal charter.

Having said that, however, we believe the ultimate solution—at least for the property and casualty industry—is enactment of legislation creating an optional Federal insurance charter as contemplated in the National Insurance Act. An optional Federal charter would give insurers and producers the choice between a single Federal regulator and multiple State regulators. It would not dismantle the State system, rather it would complement the State system with the addition of a Federal partner. It is likely that many insurers and producers—particularly those who operate in a single State or perhaps a small number of States—would choose to remain State-licensed. Large, national and international companies, on the other hand, would very likely opt for a Federal charter, thereby relieving themselves of the burden of compliance with 51 different regulatory regimes.

The National Insurance Act creates an optional Federal regulatory structure for both the life and property and casualty insurance industries; that option extends equally to both insurance companies and insurance agents and brokers (producers); and the bill carefully addresses essential elements of insurance regulation including licensure, rate approval, guaranty funds, and State law preemption. The Act preserves the State system for those that choose to operate at the State level, but offers a more sophisticated regulatory structure for insurers and producers that operate on a national and international basis in this increasingly global industry.

- S. 2509 creates a truly optional insurance regulatory system for all industry players. The structure it creates gives insurance companies and producers a real choice as to whether they want to operate under Federal or state oversight. The Act preserves the ability of insurers and insurance producers to operate under State licenses, while giving both the option of doing business under a single Federal license.
- S. 2509 gives insurance producers a choice between Federal and state oversight, and in no way increases regulatory burdens on producers. Far from creating additional licensure requirements for insurance producers, the Act has the potential of significantly reducing the regulatory burdens producers face in securing

licenses. Under the Act, insurance producers can choose to keep their existing State licenses and sell for all insurers—state and national—wherever they hold a State license. Or they can choose a single national license and sell for all insurers—state and national—in all U.S. jurisdictions. An additional benefit for producers that choose a national license is that they would be subject to a single set of requirements covering qualifications to do business, testing, licensing, market conduct and continuing education. Although the States have taken some steps in recent years toward uniform and reciprocal producer licensing requirements, it will be many years before they will enjoy such a streamlined system at the state level—if ever.

- Insurance consumers, too, have a choice. Consumers retain complete control to choose the insurers and producers with which they wish to do business. If a consumer deems it important that their insurance company be subject to the rules of a particular State or the Federal regulator, they can use that as a factor in their purchase decision.
- Consumers' product choices will expand. A single Federal regulator for national insurers will give insurance consumers expanded product choices. By offering an alternative to the multiple State regulatory that insurers must now jump through, the Federal charter will enable insurers to get products to market in a more streamlined fashion. This will enable them to address consumers needs more quickly and more specifically with products tailored to consumer needs.
- S. 2509 bolsters rather than diminishes current protections for insurance consumers. At present, insurance consumer protections are uneven from state to state. Some States have a robust system of consumer protection, while others devote fewer resources to it. Under the Act, consumers purchasing products from national insurers would have the same protections and rights whether they live in Los Angeles, Topeka, or Providence. Importantly, their rights under a policy would not change simply because they move across the Potomac from Washington to Alexandria.
- The consumer protections in S. 2509 are stronger than those in many States and provide protections that are simply unavailable in many States. For example, the Act requires every insurer to undergo both a financial and a market conduct examination at least once every 3 years. In addition, the Act provides for the creation of a Division of Fraud, Division of Consumer Affairs, and an Office of the Ombudsman to protect consumers. The Act makes the commission of a "fraudulent insurance act" a Federal crime and subjects National Insurers to Federal antitrust laws.
- The Act provides for comprehensive, rigorous oversight of insurers and insurance producers that protects producers in case of insolvency and is comparable to the best practices currently in place in the States. In addition to traditional consumer protections, the Act protects insurance consumers in another essential way: federally chartered insurers will be subject to the financial solvency oversight of a Federal regulator with the resources and staff to adequately supervise large corporations that may be beyond the capability of the States. The Act provides for financial and market conduct examinations every 3 years, allows for self-regulatory organizations to be created to police the industry, ensures that sufficient resources and Federal attention will be devoted to insurance oversight, and does not eliminate or reduce in any way the ability or effectiveness of state insurance regulation. In addition, S. 2509 leaves the State guarantee system intact to ensure policyholders are protected in case of insurer insolvency. The Act sets stringent standards that state funds must meet in order to secure national insurer participation. A national guaranty fund is established to protect policyholders in States where the guaranty fund falls short of the national standards.

The Council has been a strong advocate for legislation such as the National Insurance Act for a number of years. We realize this is a major undertaking with a great number of issues to be resolved. Political reality dictates that it will not be an easy process, nor will it be quick. We look forward to being a constructive voice in this debate.

In closing, as I noted above, improvements in the State insurance regulatory system have come about largely because of outside pressure, notably, from the Congress. Despite its ambitious reform agenda, the NAIC is not in a position to force dissenting States to adhere to any standards it sets. Thus, it is clear that congressional leadership will be necessary to truly reform the insurance regulatory regime in the United States. On behalf of The Council, I thank you for your genuine interest in these issues. We stand ready to assist you in any way.